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S. HRG. 102-5 (Pt. 9)

NATIONAL ENERGY SECURITY ACT OF 1991

(Title XV)

HEARING

BEFORE THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

S. 341

TO REDUCE THE NATION'S DEPENDENCE ON IMPORTED OIL, TO PROVIDE FOR THE ENERGY SECURITY OF THE NATION AND FOR OTHER PURPOSES

MARCH 14, 1991

PART 9

Printed for the use of the
Committee on Energy and Natural Resources

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NATIONAL ENERGY SECURITY ACT OF 1991

(Title XV)

THURSDAY, MARCH 14, 1991

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SH-216, Hart Senate Office Building, Hon. J. Bennett Johnston, chairman, presiding.

OPENING STATEMENT OF HON. J. BENNETT JOHNSTON, U.S. SENATOR FROM LOUISIANA

The CHAIRMAN. The hearing will come to order.

Today, we consider Public Utility Holding Company Act reform as part of S. 341. I consider PUHCA reform to be a very, very important part of this legislation.

I have a written statement which makes considerably more sense than what I have to say off the cuff, so I will put that in the record and invite you to read it. Conway wrote it, and therefore it is pretty good, but let me just give you a few comments.

What this bill is about is competition. Why would it be better to have a number of sources to generate electricity than to rely only on the company, whether they be exempt companies or whether they be registered holding companies?

What we found out in this country in over 200 years is that competition is better. It is better because people first of all can specialize in the generation of electricity, either in one form of that generation, be it natural gas, or coal, or nuclear, or solar—and we have specialists that do that very well.

We know that we can share the risk. You can have a very big plant and you can share that risk first of all among a number of utilities. Secondly, you can share it—you can have the generator accept the risk.

For example, I was speaking this morning to the natural gas people and talking about the fact that the big risk today probably in natural gas is not supply so much. Bud Lawrence tells me there is enough natural gas for 3,000 years, I think it is. Not seriously, but there is a lot of natural gas out there.

The risk really is the price, and producers are generators can take that risk, or help share that risk, and therefore bring natural gas more into the arena where it can be considered, and you can go right down the list of technologies and find that people who deal in those technologies can share that risk, both as to the number of people they can sell to, the number of utilities they can sell to, or the fact that they themselves, knowing that market, can share the risk.

There are advantages, and some of what we affectionately call the "just say no" crowd would say disadvantages, in the leveraging or the use of credit in building facilities. I believe there are advantages, because the disadvantages can be stipulated against contractually both by the companies who are not required to buy from EWG's and by public utility commissions who can stipulate the terms, it being their duty to protect consumers and to provide for reliability.

To say that this is controversial legislation is to put it mildly, because frankly—I mean, from the standpoint of the companies it takes away a guaranteed way to make a profit. It is a good deal to be able to rate-base a big, expensive company, to do so without risk, and to have a guaranteed profit. We understand that, and some of my best friends are in the business of doing that.

On the other hand, this is America, where competition says that sometimes it is better to be able to have a number of sources. Not that that company cannot sometimes do the very best job. We have very well-run utilities in this country—very well-run utilities, on the whole.

But if their sources of supply include some of these people out there who may be able to deliver it at a lower price because they have either better management, or because they have better financial arrangements, or because they have shared the risk, or been willing to take the risk, or have economies of scale, or whatever the reason, if they can deliver a better product at a better price, then it is better in the consumer interest, it is better in America's interest, because it makes for a stronger economy.

Now, S. 341 takes the view that three energy crises in 18 years is too much, is unacceptable to this country, and that we need to do everything we can to produce energy for ourselves, do it in America, conserve energy in America, and have alternate fuels in America, and that by doing so we will get off of our dependence on foreign oil.

The efficient generation of electricity is part of that picture, a very important part of that picture. We all remember back in the early 1970's when we were talking about PURPA and whether that would work, and there was a lot of opposition to PURPA. Now we have 30,000 megawatts produced by QF's and by those that are permitted under PURPA to generate alternate sources of energy—30,000 megawatts.

We have just about run out of steam sources and out of ideas for that, so now the new generation—more competitive we hope, revolutionary, yes—it will not put out of business any utility. It will, we think, create a new benchmark of competition so that, indeed, public utility commissions will know what are the most competitive.

Now, we are fully cognizant, and we totally respect, the arguments to the contrary, and we want to hear those and listen to them carefully. My friends in the "just say no" crowd say that we will be required to purchase nonreliable power—the favorite creations of some public utility commissions—and they point to the early days of PURPA where that, I believe, happened.

Some will say it did not, but I believe the California Commission, for example, in the early days of PURPA got carried away and made utilities purchase some power which turned out to be maybe not the best, because it was their favorite.

The California Commission points out that today the record is completely different, that their standard order number whatever it is a model of efficiency. You can debate that or not debate it.

But in order to deal with that, we have a provision which would allow people to opt out, to just file a little certificate and say we irrevocably hereby declare that for a period of up to 10 years we may not be part of an EWG or purchase from an EWG—irrevocably file that piece of paper.

We want to hear today from some as to whether that is adequate protection or whether that does any good at all. If the "just say no" crowd says that is not protection, we know the other side, including the administration, from whom we will first hear today, feels that should not be there. Well, let us hear as to whether the "just say no" crowd wants it, or that we ought to have it.

Let me say one final word before we get on with our witnesses, and that is, some would oppose this legislation because they believe that it will eventually lead to transmission access. I have a long record with respect to transmission access. I do not think it is fair. I opposed it in PURPA, and it did not happen in PURPA.

Those of you who were around in 1978 when we had PURPA remember we had a big fight at that time, and we were trying to—there were those who said, you have got to go to transmission access, and I said no, and the Senate said no, and we did not have it at that time. I am equally determined this time not to have it.

Why? First of all, I think it is not fair to require you to use your own rope to strangle yourself, and particularly offensive, I think, to pick off your best wholesale clients and use your lines to do it.

Secondly, I think it would be inordinately complicated if we tried to detail the circumstances under which it would take place—inordinately difficult, as you get into all those problems of looping and all of that.

Third, frankly I think it will evolve to whatever extent with or without PUHCA reform. It is evolving right now, consensually, which is the way it ought to be done—utilities dealing with one another, making arrangements to use their lines in ways that will be mutually advantageous.

Finally, I have made a commitment that we will not have it as part of this legislation, because I do not want it to prejudice one way or the other this legislation.

So let me just say to those who are worried that we will get over in conference or something and we will take transmission access, the answer is, it will not happen. I have made that commitment, and let us debate PUHCA reform on its own basis and not on the basis whether you fear transmission access.

There will be those who will be pushing for transmission access with or without PUHCA reform, but I will be one to resist that and we may or may not be able to pass PUHCA reform, but we will be able to defeat transmission access as part of S. 341. You can count on that.

We have got an ambitious hearing schedule today.

[The prepared statements of Senators Johnston and Wallop and the text of title XV of S. 341 follow:]

OPENING STATEMENT OF SENATOR J. BENNETT JOHNSTON
HEARING ON TITLE XV OF S. 341
REMOVAL OF IMPEDIMENTS TO INDEPENDENT POWER PRODUCTION CONTAINED IN THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
March 14, 1991

This morning the Committee on Energy and Natural Resources considers one of the most important issues facing the electric utility industry today. The question before us is whether independent power production and competition in wholesale generation should be real options for ensuring our future electric supply.

At the outset we must realize that the question is not an economic abstraction. Wholesale competition and independent power (in the form of Qualifying Facilities under PURPA) are already a reality. There are approximately 30,000 megawatts of QFs on line with more on the way. In addition, nearly half of the states have adopted, or are in the process of adopting, competitive bidding for the acquisition of new capacity by their native utilities.

When the Committee last looked at the issue of wholesale power competition more than a year ago, we could only speculate whether bidding would actually work. But now we have results and success. As of last count, 227 projects representing 11,000 megawatts had been awarded contracts using a competitive process. 67 of those projects representing over 1700 megawatts of capacity are now on line and producing power. Despite the predictions of naysayers, attrition of winning projects is within expected levels. At this point only 31 projects representing 1400 megawatts have been canceled. The remainder of winning projects appear to be going forward.

Consumers are benefiting from the development of these projects. Competitive markets provide a context for innovation and efficiency. They create incentives for performance. They ensure that the best players do the job. The end result is lower electricity prices.

However, the vigorous new growth of competition will soon wither if Congress does not take action. The PURPA box is a little too small and too rigid. Developers, both utility and non-utility, are finding that the steam requirement for cogeneration and the size and fuel limitations for small power production preclude many otherwise beneficial opportunities in power generation. In addition, critics of PURPA point out that existing limitations on utility ownership and mandatory purchase requirements don't make any particular sense in the context of a competitive wholesale market.

The logical alternative is, of course, independent power producers or IPPs. IPPs are wholesale power plants that sell power at market prices and are not subject to the size, ownership, or technological restrictions of PURPA. Unfortunately, however, the development of IPPs is presently impeded by the provisions of the Public Utility Holding Company Act of 1935. For anachronistic reasons the Holding Company Act substantially restricts the ability of companies (whether utility or non-utility) to use holding company structures for the generation of electricity. Developers generally must use holding companies to develop IPPs for financial and regulatory reasons. Thus, without changes to the Holding Company Act, significant growth of IPPs and wholesale power competition cannot take place.

I believe the time has come to loosen the choke-hold that the Holding Company Act has on independent power production. Title XV of the National Energy Security Act would do just that. In taking this step, however, we must ensure that appropriate consumer protections remain. No seller of wholesale power should be able to receive a market price if it can influence a sale because of transmission control or because it is affiliated with the buyer. Neither should retail ratepayers of a utility be put in the position of cross-subsidizing the utility's unregulated operations. I believe that Title XV together with remaining regulation under the Holding Company Act, the Federal Power Act and State law protects against these dangers, but I imagine we will hear some different opinions on that.

Clearly there is a broad base of support for Holding Company Act reform. The notion is strongly endorsed by the Administration, progressive utilities, independent producers, the entire natural gas industry (through the Natural Gas Alliance for the Generation of Electricity), architect-engineers, equipment manufacturers, various large industrial consumers, and some large public power entities. I am grateful for all their efforts.

Nevertheless, I am aware that Title XV of our energy package is controversial among other groups. In particular, the legislation is opposed by a group of utilities on one hand and certain consumer interests on the other, but for entirely different reasons. Therefore, I welcome the opportunity today to hear dissenting voices. I hope that we can continue the vigorous dialogue we have had in the past and, with a bit of good will, perhaps move toward consensus.

We have three excellent panels of witnesses today, and I look forward to their testimony.

Statement Of
Senator Malcolm Wallop (R-WY)
Ranking Republican Member
Committee on Energy and Natural Resources

hearing on amendments to the
Public Utility Holding Company Act
contained in S. 341 and S. 570

March 14, 1991

The Public Utility Holding Company Act is a fifty-five year old law designed in the 1930s to address a set of problems. Today it is having consequences unforeseen by its authors.

Both S. 341 and S. 570 contain similar provisions to address these consequences, and to update PUHCA to reflect current market realities. It is important to note, however, that neither bill proposes the repeal of PUHCA, and both contain provisions intended to protect the public interest.

As a general principle, I believe that government should get out of the way of business. But if the PUHCA issue were really that simple, I dare say that the Act would have been amended or repealed long ago.

Just as there is strong support for eliminating PUHCA's restrictions on independent power producers, there is also strong opposition. Moreover, the legislation raises a host of contentious issues such as wheeling and state public utility commission jurisdiction, to name but a few. I suspect we will hear more about this from today's witnesses.

I will work to craft a bill that enables American ingenuity to meet the power demands of tomorrow, while also protecting the public interest. If we fail, then we should move ahead with the energy package without PUHCA.

I look forward to hearing from today's witnesses about the merits of the pending legislation, and what changes they feel need to be made to improve it.

II

102D CONGRESS
1ST SESSION

S. 341

To reduce the Nation's dependence on imported oil, to provide for the energy security of the Nation and for other purposes.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 5 (legislative day, JANUARY 3), 1991

Mr. JOHNSTON (for himself and Mr. WALLOP) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

---

A BILL

To reduce the Nation's dependence on imported oil, to provide for the energy security of the Nation and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be referred to as the "National Energy Security Act of 1991".

* * * * * * *

TITLE XV.—PUBLIC UTILITY HOLDING COMPANY ACT REFORM

SEC. 15001. EXEMPT WHOLESALE GENERATORS.

(a)(1) "Exempt wholesale generator" shall mean any person who is engaged directly, or indirectly through one or more affiliates of such person as defined under section 2(a)(11)(B) of the Public Utility Holding Company Act of 1935, exclusively in the business of owning or operating all or part of one or more eligible facilities and selling electric energy at wholesale: *Provided,* That the term "exempt wholesale generator" shall exclude an affiliate of a registered holding company, which affiliate was in existence as of the date of enactment of this title, unless the Commission has consented.

(2) "Eligible facility" shall mean a facility, wheresoever located, used for the generation of electric energy exclusively for sale at wholesale (including inter-connecting transmission facilities necessary to effect such sale at wholesale), but shall exclude any facility for which consent is required under paragraph (3) and has not been obtained. For purposes of this subsection, the term "facility" shall include a portion of a facility.

(3) As of the date of enactment of this title, if a rate or charge for, or in connection with, the construction of a facility, or for electric energy produced by a facility (other than

any portion of a rate or charge which represents recovery of the cost of a wholesale rate or charge) was in effect under the laws of any State, consent with respect to such facility shall be required from any State commission having jurisdiction over such rate or charge.

(b) An exempt wholesale generator shall not be considered an "electric utility company" under section 2(a)(3) of the Act and, whether or not a subsidiary company, an affiliate, or an associate company of a holding company, shall be exempt from all provisions of the Act.

(c) Notwithstanding any provision of the Act, a holding company that is exempt under section 3 of the Act shall be permitted without condition or limitation under such Act to acquire and maintain an interest in the business of one or more exempt wholesale generators.

(d) Notwithstanding any provision of the Act and the Commission's jurisdiction as provided under subsection (e), a registered holding company shall be permitted without the need to apply for, or receive approval from the Commission, and otherwise without condition under the Act, to acquire and hold the securities, or an interest in the business, of one or more exempt wholesale generators.

(e) The issuance of securities by a registered holding company for purposes of financing the acquisition of an exempt wholesale generator, the guarantee of securities of an exempt wholesale generator by a registered holding company, the entering into service, sales or construction contracts, and the creation or maintenance of any other relationship in addition to that described in subsection (d) between an exempt wholesale generator and a registered holding company, its affiliates and associate companies, shall remain subject to the jurisdiction of the Commission under the Act: *Provided,* That—

(1) Section 11 of the Act shall not prohibit the ownership of an interest in the business of one or more exempt wholesale generators by a registered holding company (regardless of where facilities owned or operated by such exempt wholesale generators are located), and such ownership by a registered holding company shall be deemed consistent with the operation of an integrated public utility system; and

(2) The ownership of an interest in the business of one or more exempt wholesale generators by a registered holding company (regardless of where facilities owned or operated by such exempt wholesale generators are located) shall be considered as reasonably incidental, or economically necessary or appropriate to the operations of an integrated public utility system.

SEC. 15002. OWNERSHIP OF EXEMPT WHOLESALE GENERATORS AND QUALIFYING FACILITIES.

The ownership by a person of one or more exempt wholesale generators shall not result in such person being considered as being primarily engaged in the generation or sale of electric power within the meaning of sections 3(17)(C)(ii) and 3(18)(B)(ii) of the Federal Power Act, as amended.

SEC. 15003. ELECTION TO AVOID PURCHASE FROM OR OWNERSHIP OF EWGS.

(a) An electric utility company that intends to avoid purchasing electric energy from exempt wholesale generators may file a declaration of this intent with the Federal Energy Regulatory Commission in such form as such commission may prescribe. Such declaration shall specify a period of no longer than ten years during which such declaration shall remain in effect and shall be irrevocable during the period specified. An electric utility company may file such a declaration from time to time as it finds desirable.

(b) Upon the filing of a declaration under subsection (a), the electric utility company making the filing shall, without the need for action by the Federal Energy Regulatory Commission or any other body, be prohibited from purchasing electric energy from any exempt wholesale generator during the period specified in the declaration.

(c) No State commission shall impose any penalty, directly or indirectly, through exercise of ratemaking authority or otherwise, upon an electric utility company or an affiliate or associate company thereof, on account of the filing of a declaration as provided under subsection (a), either in advance of such filing or subsequently.

(d) Notwithstanding any other provision of this title, no electric utility company that has filed a declaration under subsection (a), nor any affiliate or associate company thereof, shall acquire or own an interest in the business of an exempt wholesale generator during the period in which such declaration remains in effect. Nor shall any such electric utility company, or affiliate or associate company thereof, make any offer, during the period in which such declaration remains in effect, to sell electric energy from an exempt wholesale generator in whose business it would acquire or own an interest after such declaration expires.

(e)(1) Any violation of the prohibitions of this section shall be deemed to constitute a violation of the Federal Power Act, as amended, and the provisions of such Act shall apply to the enforcement, and imposition of penalties for violations, of the prohibitions of this section.

(2) For purposes of the enforcement of the prohibitions of this section, a State commission shall be deemed to be a

person under section 314 of the Federal Power Act, as amended.

SEC. 15004. PRESERVATION OF STATE AUTHORITY.

Except as provided in section 15003, nothing in this title shall preempt or otherwise restrict such power as a State commission may have, in accordance with State and Federal law and in the absence of the enactment of this title, to judge the prudence of a purchase of electric energy at wholesale, allow or disallow the inclusion of the cost of such a purchase in rates subject to such commission's jurisdiction, or otherwise exercise its functions.

SEC. 15005. REFERENCES TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935.

For purposes of this title, all references to "the Act" shall mean the Public Utility Holding Company Act of 1935, as amended. All of the terms used in this title and defined in the Public Utility Holding Company Act of 1935 shall have the same meaning as defined therein.

○

The CHAIRMAN. Senator Bumpers.

STATEMENT OF HON. DALE BUMPERS, U.S. SENATOR FROM ARKANSAS

Senator BUMPERS. Mr. Chairman, I have an opening statement I will put in the record.

I want to express the precise concerns of the Arkansas Public Service Commission. I think it is reflective of the concerns of most of NARUC, and I would just like to read two paragraphs from a statement that they have filed with this committee:

> Unlike most utilities, a utility subsidiary of a registered holding company incurs most of its power supply costs by purchasing capacity and energy from other subsidiaries of the holding company.
>
> These wholesale transactions are regulated by the FERC rather than State commissions. Recent judicial decisions regarding the treatment of these wholesale transactions have placed the future of State regulation in doubt, even if States are creating innovative means to encourage efficient, least-cost planning and competition among sellers of power.
>
> Title XV would lead to many more wholesale transactions, thus multiplying the current level of uncertainty. Enacting title XV without creating a predictable, rational relationship between Federal and State regulation and without ensuring that essential transmission facilities are available to all wholesale competitors, will hamper State efforts at least-cost planning and leave the industry operating less efficiently than it does right now.

I just wanted to make that public, and I will put my statement in the record.

[The prepared statement of Senator Bumpers follows:]

STATEMENT OF SENATOR DALE BUMPERS

Mr. Chairman, I complement you for your work on this issue. In our debate over amending the Holding Company Act, we are really talking about the future structure of the electric utility industry and about establishing statutory guidelines for the operation of an industry which may be structured very differently than the one we are now familiar with.

So I think it is important that this Committee consider carefully the ramifications of your bill for consumers and ratepayers and consider carefully whether your bill will assure that fair competition can occur between the various entities that want to build new generating capacity in the future.

One particular issue that I feel a personal obligation to address is the question of state regulatory authority. The Arkansas Public Service Commission has submitted an excellent statement detailing their concerns on this issue, many of which I share. Often in this debate when state regulatory authority is discussed the unique problems of state commissions in states served by multi-state holding companies are not adequately addressed. Let me quote briefly from the Arkansas Commission statement:

"Unlike most utilities, a utility subsidiary of a registered holding company incurs most of its power supply costs by purchasing capacity and energy from other susidiaries of the holding company. These wholesale transactions are regulated by the FERC rather than state commissions, Recent judicial decisions regarding the itreatment of these wholesale transactions have place the future of state regulation in doubt, even as states are creating innovative means to encourage efficient,least cost planning, and competition among sellers of power.

Title XV would lead to many more wholesale transactions, thus multiplying the current level of uncertainty. Enacting Title XV without creating a predictabble rational relationship between federal and state regulation, and without ensuring that essential transmission facilities are available to all wholesale competitors, will hamper state efforts at least cost planning an leave the industry operating less efficiently than it does now."

I hope the witnesses today will offer up some suggestions on how Congress can address these needs in PUHCA reform legislation.

Senator **Bumpers**. Mr. Chairman, I did not realize you had taken the position that transmission access would not be part of this bill. That causes me a little bit of a problem, but I will stay open minded on that.

The **Chairman**. Let me say with respect to Pike County and the Mississippi case, we really want to solve that problem if we can. It is enormously complicated, and we are going to deal with that this afternoon. We have a draft which we have been circulating around about how to fix that problem, and we hope we can do that.

It is related to—well, it is part of this legislation, because it could be a purchase from an EWG for a registered holding company which would have multistate involvement. So we want to fix that, and it is not easy to do, but it is our purpose to try to do that, but we will deal with that this afternoon.

Now, this morning our first panel is composed of Edward H. Fleischman, Commissioner with the FCC, who is accompanied by Marianne K. Smythe and William C. Weeden, Linda Stuntz, Deputy Under Secretary of DOE who has done so much on the NES, Cynthia A. Marlette, Associate General Counsel for Hydroelectric and Electric of the FERC.

Ladies and gentlemen, we have got a very big group of panelists today to deal with, and so I want to ask the witnesses if they will to hold their testimony in chief to about—try to hold it to 6 minutes, if you can, so we can allow time for questioning.

If my colleagues—and I do not want to say I hope we do not have any opening statements. Last time we did that when we had ANWR, I said I did not want to ask, unless somebody has got an irresistible impulse on the committee to say something, let us go straight to the witnesses, and everyone had an irresistible impulse and they all left and I was here until 1:30 p.m.

So let me ask, if the Senators really I hope you will not insist, and if you insist I will give you a chance, but I hope you will not insist.

STATEMENT OF HON. DON NICKLES, U.S. SENATOR FROM OKLAHOMA

Senator **Nickles**. Mr. Chairman, I have a statement that would not have taken as long as your request, but I will ask that you put it in the record.

[The prepared statement of Senator Nickles follows:]

Nickles

STATEMENT OF SENATOR DON NICKLES
BEFORE THE COMMITTEE ON ENERGY AND NATURAL RESOURCES
ON AMENDMENTS TO THE PUBLIC UTILITY HOLDING COMPANY ACT

MARCH 14, 1991

Mr. Chairman, the issue of PUCHA reform is very complex and complicated and reforms should not be undertaken lightly. I don't like regulated industries. I like competition and free enterprise. But, from what I understand, the reforms proposed in both the Chairman's bill and in the Administration's National Energy Strategy open up the field for competition, but gives one side an advantage over the other. Neither proposal provides for a level playing field between the regulated utilities and the Independent Power Producers (IPPs).

Those who support PUCHA legislation do so on the grounds that reform would create new capacity through promoting the construction of new powerplants, would increase competition in the wholesale electrical generation market and would allegedly reduce costs to consumers. Those who oppose PUCHA reform raise serious concerns about how the proposed changes would impact on system reliability and assert that the price of power would increase. State public utility commissions oppose the legislation as currently formulated because it would deny them jurisdiciton over IPPs, which would instead be under FERC jurisdiction. Every side has compelling arguments.

I believe in a free market system where everyone has an equal chance to compete. However, under current law, proponents of PUCHA reform assert that public utilities are in essence a monopoly with little competition. On the other hand, public utilities assert that under the proposed reforms, IPPs will enter the market as highly leveraged companies giving them an unfair rate advantage and placing the reliability of their service in question. As such, is that in the long term interest of supply?

These are difficult questions to answer. I look forward to working on these complicated issues. No one has the answers yet, but I would like us to come up with something that is positive and fair. It's not fair to compete on a non-level playing field. We don't want to do more damage than good with this bill. Hopefully, during the course of these hearings and during markup, we will come to some conclusions, be it current law, reform, or all out competition.

The **Chairman**. Let the record reflect you did not request, but I would have let you read it if you had insisted, but we will put it in the record. Thank you very much, Senator Nickles.

Senator Craig.

Senator **Craig**. Mr. Chairman, assuring you that this is not a precedent, I have nothing to say and would urge that we get on with the witnesses.

The **Chairman**. Thank you very much. I appreciate the cooperation of my colleagues, so let us begin with Ed Fleischman with the SEC, and if all the witnesses would come to the table, please.

STATEMENT OF HON. EDWARD H. FLEISCHMAN, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY MARIANNE K. SMYTHE, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT; AND WILLIAM C. WEEDEN, ASSISTANT DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT

Mr. **Fleischman**. Thank you, Mr. Chairman.

I am Edward Fleischman, one of the SEC commissioners. I appreciate the opportunity to testify before the committee on behalf of the SEC with respect to title XV of S. 341, the Proposed National Energy Security Act.

As you were kind enough to indicate, Mr. Chairman, I am accompanied this morning by the Director of our Division of Investment Management, Ms. Smythe, and the Assistant Director, Mr. Weeden.

Both title XV and subtitle A of title IV of the administration's proposed National Energy Strategy Act, Senate bill number 570 would exempt so-called EWG's, independent generators marketing power at wholesale only, from the requirements of the Public Utility Holding Company Act of 1935, which the SEC administers.

Both bills seek, as you said Mr. Chairman, through encouragement of competition and removal of unnecessary regulation, to encourage additional generation of electric power for sale at wholesale in order, ultimately, to reduce the consumer cost of electricity and to reduce the Nation's dependence on foreign sources of energy.

It has, for several years, been the SEC's view that the system of pervasive regulation created by the 1935 act must be refashioned to address changing economic and regulatory conditions.

The SEC is empowered by Congress to adopt exemptive rules in the public interest or for the protection of investors or consumers and consonant with the purposes of the act. But the SEC's exemptive authority would not extend to effectuating the broad exemption that S. 341 and S. 570 contemplate. And of course, the SEC can only work within the limits of Congressionally bestowed authority.

Given the agreement between Congress and the administration on the policy objectives of S. 341 and S. 570, the SEC can advise you, this morning, of its belief that adequate safeguards are provided, in the disclosure requirements under the securities laws administered by the SEC and in the market itself, for the protection of the interest of investors in the securities of every type of generating company and generating system: EWG's, unitary utilities, presently exempt utility holding companies and registered utility holding companies. And the SEC can also advise you of its belief that the interest of consumers, generally, can be protected by other regulatory entities: The Federal Energy Regulatory Commission, determining market-based, wholesale rates for EWG's at the Federal level, and—while the pattern of State control remains uneven—the various utility regulatory commissions at the State level.

Detailed comments on the proposed legislation, Mr. Chairman, are included in the written testimony that the SEC has submitted to the committee.

The SEC is grateful for the opportunity to present its views to this committee, and I shall, of course, be pleased to respond to any questions that you or the other members of the committee have.

[The prepared statement of Mr. Fleischman follows:]

TESTIMONY OF

EDWARD H. FLEISCHMAN, COMMISSIONER
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING S. 341

BEFORE THE COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

MARCH 14, 1991

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

STATEMENT OF THE HONORABLE EDWARD H. FLEISCHMAN
COMMISSIONER OF THE
SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

CONCERNING S. 341

March 14, 1991

Chairman Johnston and Members of the Committee:

I am Edward Fleischman, one of the Commissioners of the Securities and Exchange Commission ("Commission"). In addition to its other major responsibilities, the Commission administers the Public Utility Holding Company Act of 1935 ("1935 Act"). I appreciate this opportunity to testify before you on behalf of the Commission regarding Title XV of S. 341, the "National Energy Security Act of 1991."

Both Title XV of S. 341 and Subtitle IV A of the Administration's National Energy Strategy Act, S. 570, would exempt from the 1935 Act certain wholesale power generators. The bills both seek, through such exemptions, to encourage the development of a national wholesale electric power market. Exempting wholesale power generators from the 1935 Act would remove unnecessary regulation and encourage competition in order to reduce the cost of electric power for consumers and, ultimately, reduce our dependence on foreign sources of energy.

As President Bush said last month, in announcing the National Energy Strategy, we must find ways "to increase energy efficiency and conservation," to "find more domestic oil and gas," and to "reduce our vulnerability to foreign oil supply disruptions." 1/ Further, as Energy Secretary Watkins noted in his letter to Speaker Foley regarding the Administration bill, "[r]egulatory structures that were appropriate in the 1930s are no longer appropriate" for this industry. 2/ Indeed, as you know, the Commission has long favored repeal of the 1935 Act. 3/ Exempting wholesale power generators from the 1935 Act seems a sensible and appropriate step in the direction of modernizing public utility regulation.

There are some differences in the details of the 1935 Act provisions of S. 341 and S. 570, particularly in terms of their treatment of exempt wholesale generators that are part of registered or presently exempt public-utility holding company systems, but these differences seem less important than their similar goal. The 1935 Act provisions of both bills respond, in a sensible if limited way, to the recent changes in the nature of the electric utility industry.

BACKGROUND

Historically, vertically-integrated investor-owned utilities that controlled generation, distribution and transmission

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1/ Speech by President George Bush to the Economic Club of New York City, February 6, 1991.

2/ Letter from James D. Watkins to Thomas S. Foley, March 4, 1991.

3/ Statement of the U.S. Securities and Exchange Commission Concerning Proposals to Amend or Repeal the Public Utility Holding Company Act of 1935, June 2, 1982, pp. 44-45. Of course, so long as the 1935 Act remains the law, the Commission will administer it to protect the public interest and the interest of investors and consumers.

facilities dominated this industry. The profile of the industry began to change, however, in 1978 when the Congress enacted the Public Utility Regulatory Policies Act of 1978 ("PURPA"). 4/ Congress intended PURPA to stimulate alternative energy production, thereby reducing the country's dependence on foreign oil. To that end, PURPA granted qualifying facilities ("QFs") significant regulatory advantages over traditional generating facilities. Among other things, most QFs are exempt from the 1935 Act.

PURPA opened the door to nonutility participation in the production of electric energy. This nontraditional industry has grown. Increasingly, developers seek to construct, own and operate independent power projects ("IPPS") that do not meet the narrow requirements for QF status under PURPA. 5/ Because IPPs are generally project-financed, using a holding company structure, IPP developers must clear the hurdles of the 1935 Act. As you are

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4/ 16 U.S.C. §§ 2601-2645 (1990).

5/ The term IPP generally denotes a person (utility or nonutility) who owns a wholesale generating facility and who, because of a lack of market power, is permitted under the Federal Power Act to charge an unregulated price for the power that the facility produces.

In 1988, the Federal Energy Regulatory Commission ("FERC") issued three Notices of Proposed Rulemaking that would have streamlined regulation of IPPs. FERC Docket Nos. RM88-4-000 (independent power producers), RM88-5-000 (competitive bidding) and RM88-6-000 (determination of avoided cost). The proposed regulations were intended to increase supply options in the wholesale electric energy market, in accordance with FERC's statutory responsibilities under the Federal Power Act, 16 U.S.C. §§ 791a-825u (1990), and the PURPA. The controversial rulemaking has been abandoned. The FERC has said it will, however, continue to consider regulatory relief for IPPs on a case-by-case basis.

aware, the 1935 Act is a broad regulatory statute directed toward the organization and structure of public-utility holding companies and their subsidiaries. The strictures of the 1935 Act could impede the plans of a market-oriented IPP developer. The proposed legislation seeks to eliminate these strictures, by creating a broad exemption from the 1935 Act for persons who participate in independent power production. Title XV of S. 314 defines these persons as "exempt wholesale generators" ("EWGs") and exempts them from all provisions of the 1935 Act.

On the surface, the simple removal of EWGs from the 1935 Act would seem to accomplish the objectives of S. 341 and S. 570. The difficulty inherent in the proposed legislation, however, is that creation of EWGs requires consideration not only of the 1935 Act but also of the impact of EWGs on existing state regulation. Over fifty years ago, Congress determined that it was necessary to place significant constraints upon the structure of the United States electric and gas industry, to protect the public interest and the interests of investors and consumers. Congress entrusted the Commission, as the agency with expertise in financial transactions and corporate finance, with regulation of the corporate structure of public-utility holding companies and their affiliates. Although the Federal Energy Regulatory Commission ("FERC") and the states regulate rates and the actual utility operations, the 1935 Act has had a pervasive indirect effect on these matters, by determining the structure of the industry itself. 6/

On September 19, 1988, the Commission offered testimony before the House Subcommittee on Energy and Power of the Committee on Energy and Commerce, concerning a legislative proposal by the Edison Electric Institute to remove the 1935 Act as an impediment to the development of IPPs. 7/ In that testimony, the Commission

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6/ The 1935 Act includes two separate but complementary pieces of legislation. Title I, the Public Utility Holding Company Act, charges the Commission with the regulation of the corporate structure and financing of public-utility holding companies. Title II, designated Parts II and III of the Federal Power Act, charges the FERC with oversight of interstate wholesale sales of electricity. As the Commission explained in *American Elec. Power Co.*, 46 S.E.C. 1219, 1223 (1978):

> [Our] control over [registered holding] companies relates only to their structure, to their intra-system transactions, and to their finances. We have no power over their dealing with their customers, retail or wholesale.

See also City of Lafayette v. SEC, 464 F.2d 941 (D.C. Cir. 1971), *aff'd sub nom. Gulf States Utilities v. FPC*, 411 U.S. 797 (1973). The 1935 Act does not regulate the operations of utility companies as such. The Commission has no jurisdiction over sales of energy. The FERC focuses upon the technological and policy issues associated with energy generation and transmission. *See generally* Welch, *Functions of the Federal Power Commission in Relation to the Securities and Exchange Commission*, 14 G.W.L. Rev. 81 (1945).

7/ Statement of Marianne K. Smythe, Associate Director of the Division of Investment Management, Securities and Exchange Commission, ~~Before~~ the House Subcommittee on Energy and Power of the Committee on Energy and Commerce Concerning Independent Power Producers (Sept. 14, 1988).

observed that the policies underlying the development of IPPs cannot go forward without amendment or repeal of the 1935 Act. 8/

This testimony will focus upon the background and basic principles of the 1935 Act, and its effect on IPP development. The testimony will then respond to the Committee's questions regarding Title XV of the National Energy Security Act of 1991 and identify areas of concern relating to its implementation.

THE 1935 ACT

Section 1(c) of the 1935 Act proclaims the statute's policy-

> to meet the problems and eliminate the evils as enumerated in this section [1] . . . and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

The 1935 Act is one of the most pervasive of the New Deal regulatory plans, adopted by Congress in order to reform the United States gas and electric utility industry, after extensive studies by the Federal Trade Commission and a Congressional committee had documented numerous abuses resulting from an unrestrained misuse of the holding company structure. 9/ By 1932, approximately 49%

8/ The Commission is on record as recommending repeal of the 1935 Act. If Congress were to repeal the 1935 Act at this time, then, of course, the existing statutory impediments posed to EWGs would be eliminated and consideration of the proposed legislation would be unnecessary. Unless and until the 1935 Act is repealed, the Commission will administer the 1935 Act to protect the public interest and the interest of investors and consumers.

9/ Pursuant to a Senate Resolution in 1928, the Federal Trade Commission undertook a study of the entire electric and gas industry that spanned nine years and ultimately comprised 101 volumes. Federal Trade Commission Report to the Senate, "Utility Corporations," S. Doc. No. 92, 70th Cong., 1st (continued...)

of the investor-owned utilities were controlled by three holding companies. Virtually all the holding company systems were characterized by extremely complex capital structures that made it difficult, if not impossible, for investors to analyze the quality of earnings and the financial condition of the companies in which they were investing. In the early 1930s, many of the holding companies collapsed, leaving investors with billions of dollars of losses.

Congress found the operation of these systems detrimental to the interests of United States consumers and investors, and concluded that the systems' interstate character had rendered state regulation largely ineffective. 10/ The specific abuses identified by Congress included the pyramiding of voting control, overcapitalization, securities issued upon the basis of fictitious

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9/(...continued)
Sess. 24 (1935) (hereinafter, "FTC Report"), conducted pursuant to S. Res. 83, 70th Cong., 1st Sess. (1928). A second, six-volume study was conducted by the House Interstate and Foreign Commerce Committee between 1933 and 1935. Report on the Relation of Holding Companies in Power and Gas Affecting Control, H.R. Rep. No. 827, 73rd Cong., 2d Sess. (6 Vols. 1933-35), made pursuant to H.R. Res. 59, 72d Cong., 1st Sess. (1932) and H.R.J. Res. 572, 72d Cong., 2d Sess. (1933).

10/ Through the holding company structure, management and control were shifted from the operating public utility company, which was subject to state regulation, to the parent holding company, which was often organized under the laws of another state and was not within the jurisdiction of utility regulators in any state. Service companies, which frequently charged exorbitant fees to operating companies for financial and managerial services, were also organized in foreign states, making their records and accounts inaccessible to local state regulators.

and unsound asset values, intrasystem profiteering on transfers of assets, financial mismanagement, excessive intrasystem management fees and service charges, the concentration of economic power not susceptible to state regulation, and the expansion of holding company systems without regard to the integration and coordination of related utility properties. 11/ The 1935 Act, which was intended to eliminate these abuses, is both complex and far-reaching. Its fundamental goal is the simplification of public-utility holding company systems, in most cases limiting their operations to a single geographic area and a single line of utility business, gas or electric.

A "holding company" is generally defined as "any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company." 12/ An "electric utility company," for purposes of the 1935 Act, is "any company that owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale." 13/ Because an IPP generates electrical energy, it would be an electric utility company, and any

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11/ Section 1(b) of the 1935 Act.

12/ Section 2(a)(7)(A) of the 1935 Act. The Commission can impose regulation as a "holding company" under section 2(a)(7)(B) if, after notice and hearing, it determines that any person exercises sufficient controlling influence over a utility to make it necessary or appropriate in the public interest or for the protection of investors or consumers to treat that person as a holding company.

13/ Section 2(a)(3) of the 1935 Act.

company that owns, controls, or holds with power to vote 10% or more of the voting securities of a company which owns or operates an IPP would be a public-utility holding company under the 1935 Act.

Unless eligible for an exemption, a holding company is required to register under the 1935 Act. 14/ Registration, which subjects the entity to restrictive financial and operational requirements and limits the operations of the system with geographic and functional integration standards, is almost invariably an unacceptable course for an IPP developer. 15/ A company seeking to invest in a single IPP might qualify as an exempt holding company under one of five narrowly drawn provisions in section 3(a) of the 1935 Act. 16/ It is unlikely, however, that

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14/ Section 5 of the 1935 Act.

15/ Under section 11 of the 1935 Act, the holding company would be limited to a single "integrated" gas or electric utility system with a simple and fair capital structure, operating in a contiguous geographic area. Nonutility businesses could be acquired or retained only if they were functionally related to the utility operations of the holding company system. Michigan Cons. Gas Co. v. SEC, 444 F.2d 913 (D.C. Cir. 1971). The limits of diversification by registered holding companies are being contested in a proceeding presently sub judice by the Commission. In the Matter of CSW Credit, Inc. and Central and South West Corp., Admin. Pro. File No. 3-7027 (Feb. 23, 1989) (argued Dec. 6, 1990).

16/ The two most widely-used exemptions are those provided in sections 3(a)(1) and 3(a)(2) of the 1935 Act, generally known as the "intrastate exemption" and the "predominantly a public utility exemption," respectively. Even if the applicant qualifies objectively for an exemption under section 3, the Commission may nonetheless deny or limit the exemption if it finds the exemption "detrimental to the public interest or the interest of investors or consumers."

the company would continue to qualify for exemption upon acquiring a second IPP. 17/

In any event, a company seeking to acquire an interest in a second IPP must clear the hurdle of section 9(a) of the 1935 Act. That section requires Commission approval of an acquisition by "any person," be it a registered holding company, exempt holding company, free-standing utility, nonutility or natural person, if the acquisition would result in that person becoming an affiliate (owning 5% or more of the voting securities) of more than one public utility.

In passing upon applications under section 9(a), the Commission is required to apply the criteria set forth in section 10 of the 1935 Act, including whether the acquisition will unduly concentrate control of utility systems, whether the purchase price is reasonable, whether the purchase unduly complicates the capital of the resulting system, and whether the transaction serves the public interest by tending toward the economic and efficient development of an integrated public utility system. The application of the "two-bite" rule effectively forecloses IPPs from

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17/ The "intrastate exemption" requires, inter alia, that each material public-utility subsidiary company be organized and carry out its business substantially in the same state as the holding company. While an IPP could use this exemption for projects in a single state, it would not be useful for the numbers of IPPs that want to build in several states. Neither would the "predominantly a public utility" exemption prove useful to the typical IPP that wants to finance and control each power project through a separate subsidiary rather than have appreciable utility operations at the holding company level.

undertaking projects in widely dispersed geographic locations; such projects could not meet the integration requirements of section 10(c) of the 1935 Act. A company with IPP or other utility operations in Ohio could not, for example, acquire an IPP in California.

The Commission has attempted, within the limits of the 1935 Act, to accommodate the development of independent power production. Because the 1935 Act bases its presumption of control on the ownership of voting stock, a company could purchase nonvoting common or preferred stock of an IPP and gain the economic benefit of IPP ownership, without becoming a "holding company." 18/ In the alternative, the parties could establish a limited partnership with an exempt holding company as the general partner and equity participants as limited partners. 19/ Each of these approaches, however, has its limits. Under section 3(d) of the 1935 Act, the Commission could exempt a specified class of persons from the definition of "subsidiary company" or "affiliate" within the meaning of the 1935 Act. 20/ This section does not have the

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18/ See, e.g., Ocean State Power, SEC No-Action Letter (Feb. 16, 1988).

19/ See, e.g., Colstrip Energy Limited Partnership, SEC No-Action Letter (June 30, 1988); Catalyst Energy Co., SEC No-Action Letter (Jan. 21, 1988); see also John Hancock Mutual Life Ins. Co., SEC No-Action Letter (June 23, 1986).

20/ Section 3(d) provides:

> The Commission may, by rules and regulations, conditionally or unconditionally exempt any specified class or classes of persons from the obligations, duties, or liabilities imposed upon

(continued...)

breadth of the general exemptive provision in section 6(c) of the Investment Company Act of 1940, 21/ and could not, by its terms, effect the broad exemption from the 1935 Act that S. 341 and S. 570 would provide for EWG investors and EWGs. 22/ The Commission

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20/(...continued)

> such persons as subsidiary companies or affiliates under any provision or provisions of this title, and may provide within the extent of any such exemption that such specified class or classes of persons shall not be deemed subsidiary companies or affiliates within the meaning of any such provision or provisions, if and to the extent that it deems the exemption necessary of appropriate in the public interest or for the protection of investors or consumers and not contrary to the purposes of this title.

21/ Section 6(c) of the Investment Company Act of 1940, in pertinent part, provides:

> The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of person, securities, or transactions, from any provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

We note that Congress with its enactment of PURPA in 1978 provided a framework for initial development of an independent power industry, which included exemption from the 1935 Act for most QFs.

22/ For the partial exemption of EWGs achievable under section 3(d), the Commission would have had to have resolved, favorably, the question whether such exemption for EWGs would be appropriate in the light of the purposes and policies of the 1935 Act.

cannot independently remove the statutory impediments; it can only work within them.

THE 1935 ACT PROVISIONS OF S. 341 AND S. 570

The relevant provisions of both S. 341 and S. 570 are intended to remove these impediments in the 1935 Act. Sections 15001(a) and (b) of S. 341 define an "exempt wholesale generator" ("EWG"), and exempt it from the definition of "electric utility company" and, generally, from all provisions of the 1935 Act. Section 15001(c) allows exempt holding companies to acquire and maintain interests in EWGs without limit or condition under the 1935 Act. Section 15001(d) permits a registered holding company to acquire an interest in one or more EWGs without Commission approval. Section 15001(e), however, requires Commission approval of a registered company's issuance of securities to finance the acquisition of an EWG or of a registered company's guarantee of the securities of an EWG, and further provides for Commission oversight of service, sales or construction contracts, and any other relationship between the EWG and an affiliated registered holding company and its affiliates and associate companies.

S. 570 contains substantially similar provisions defining EWGs, exempting them from the 1935 Act, and allowing exempt or registered holding companies to acquire interests in EWGs. Section 402(b) of S. 570, however, allows the Commission, upon application, to terminate the exemption under section 3(a) of the 1935 Act, of a holding company with an EWG if: (1) the holding company has not established appropriate means to determine the allocation of costs between the EWG and any affiliated company that provides retail electric service, or (2) the EWG enters into an affiliate power sales contract without each affected state commission having approved the contract.

You have asked the Commission to address the following questions concerning Title XV of S. 341:

1. **What are the consumer implications of Title XV? Does the legislation create any regulatory gaps or remove significant consumer protections against such matters as cross-subsidy by captive ratepayers in favor of unregulated business? Does the legislation fundamentally alter the structure of the Holding Company Act?**

As you are aware, the Commission is charged with the duty of administering the 1935 Act to protect the public interest and the interests of investors and consumers, the so-called "protected interests." 23/ With respect to the interests of consumers, the 1935 Act does not regulate utility operations or rates as such. It does, however, affect these matters indirectly by regulating the structure of holding companies.

Title XV would eliminate the Commission's review of proposed EWG acquisitions. The legislation will have no direct impact on power sales contracts between a holding company and its affiliate EWG because the 1935 Act's jurisdiction does not extend to sales of power. Although Title XV would permit a holding company to own

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23/ The determination whether S. 341 will further the public interest in a sound United States electric utility industry is, of course, committed to the Congress. The Commission believes that there exist adequate safeguards, in the disclosure requirements under the other securities laws and in the market itself, to protect the interests of investors.

and operate an EWG anywhere in the world, the legislation would protect consumers of power from affiliates of registered holding companies against any additional risk, by retaining the 1935 Act's prohibitions on cross-subsidization and the general requirement that affiliate transactions be "at cost."

The Commission believes that consumer interests generally can be protected by other federal and state regulators. Much of the consumer protection will follow from the FERC and its determination to grant the EWG market-based rates. To make that determination, the FERC generally requires that the seller does not have market power over the buyer and that there be no evidence of potential affiliate abuse.

In addition, the states have the capacity to provide a measure of protection to consumers. At present, the 1935 Act, by restricting the corporate structure of public utilities, operates to facilitate effective state regulation. 24/ Since Title XV removes certain of the 1935 Act's restrictions, the Commission points out that the states remain unable to regulate interstate holding companies directly in a comprehensive fashion. Although there has been a significant increase since 1935 in the effective reach of state utility regulation, the Commission has recognized that the pattern of state control over operating utilities and

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24/ Congress intended that the Commission's work be coordinated with and complement the work of state commissions. See, e.g., sections 6(b), 8, 9(f), 18, 19 and 20(b) of the 1935 Act.

their relationships with affiliates remains uneven. 25/ Certain provisions of S. 570 would provide an added safeguard by retaining limited Commission involvement to facilitate effective state regulation. 26/ It is, of course, for Congress to decide how the possibility of greater competition balances with the possibility of reduced protection for consumers.

2. **As a matter of regulatory policy, the SEC has generally required registered holding companies to maintain a 65% debt-equity ratio on a consolidated basis. However, exempt wholesale generators (EWGs) under Title XV are likely to employ a higher degree of leverage. Does it make sense for EWG debt which is non-recourse with respect to a registered holding company or its utility affiliates to be considered by the SEC in applying the 65% ratio to the consolidated balance sheet? How is the SEC likely to treat this matter?**

Although the EWG itself would be exempt from all provisions of the 1935 Act, a registered holding company would remain subject to Commission review of any financing arrangements on behalf of the EWG. A registered holding company thus would have to obtain an order of the Commission, under sections 6 and 7 of the 1935 Act, before issuing securities to finance the acquisition of the EWG or

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25/ Statement of the U.S. Securities and Exchange Commission Concerning Proposals to Amend or Repeal the Public Utility Holding Company Act of 1935, June 2, 1982, pp. 44-45, referenced *supra*, note 2.

26/ S. 570, for example, would allow the Commission to terminate the exemption of a holding company that failed to establish appropriate means of cost allocation between an EWG and any affiliate that provides retail electric service. The Commission could also challenge an exemption where an EWG enters into a power sales contract with an affiliate that provides retail electric service without the approval of all affected state commissions. Title XV, by comparison, shields exempt holding companies from any Commission challenge related to the ownership or operation of an EWG.

to replenish treasury funds spent on such financings. Section 7 of the 1935 Act requires the Commission to consider, among other things, whether the security is reasonably adapted to the security structure of the company issuing the security and to other companies in the registered system.

This section speaks to Congress' concern that the traditional electric utility company have a simple capital structure and incur only those amounts of debt that can be adequately serviced by the operations of the utility. As a matter of regulatory policy, the Commission has generally required that a registered holding company system and its public-utility subsidiary companies maintain a 65/30 debt/common equity ratio; the balance of the capital structure, 5%, is generally preferred equity. 27/ To the extent the registered holding company guarantees the debt of a subsidiary EWG or borrows to finance its investment in that EWG, these obligations will limit the amount of credit available to other entities in the system.

The Commission recognizes, of course, that EWGs will not be traditional electric utility companies, so traditional financial standards will not necessarily apply. EWGs will be project-financed entities generally characterized by large amounts of nonrecourse debt, a transactional structure intended to limit the exposure on the debt to the EWG itself. Thus, if an EWG fails,

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27/ The Commission has proposed for public comment a rule that would allow public-utility subsidiary companies of registered systems to issue and sell securities in specified circumstances without adhering to this ratio. *See* Holding Co. Act Release No. 25059 (Mar. 19, 1990) (proposed amendment to rule 52 under the 1935 Act).

its creditors will be expected to look only to the assets of the EWG for satisfaction of their claims. The exposure of a registered holding company thus should be limited to its investment in the EWG and the amount, if any, of EWG debt that the parent has guaranteed.

The 1935 Act creates a system of pervasive economic regulation that must be refashioned from time to time to keep pace with changing economic and regulatory climates. 28/ Even in its analysis of traditional utility financings, the Commission has recognized that there are times and circumstances that warrant deviation from established guidelines. 29/ For these reasons, the Commission can be expected to adopt appropriate standards for evaluating investments in EWGs. 30/

3. **Under Title XV the issuance of securities by a registered holding company for purposes of financing an EWG would require SEC approval under the existing provisions of the Holding Company Act. What is the nature of the SEC's review of securities issuance? Does this review stand as an obstacle to investment by registered holding companies in EWGs?**

Under Title XV, the Commission would retain an anomalous partial authority over the activities of registered holding companies acquiring EWGs. We use the term "anomalous" because, although the EWG itself would be exempt from all provisions of the

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28/ Ohio Power Co., 46 S.E.C. 332, 335 n.9 (1976).

29/ See, e.g., Northeast Utilities, SEC Holding Co. Act Release No. 25221 (Dec. 21, 1990); EUA Power, Inc., SEC Holding Co. Act Release No. 25080 (Apr. 30, 1990).

30/ The Commission would be aided by the provision of a standard in S. 341 to guide it in its consideration of applications by registered holding companies to finance EWG affiliates. We would be pleased to work with the Congress to formulate such a standard.

1935 Act, a registered holding company would remain subject to substantive review under sections 6 and 7 of the 1935 Act with respect to any financing arrangements on behalf of the EWG.

Sections 6 and 7 generally require Commission authorization for the issuance and sale of securities by registered holding companies or their subsidiaries. Section 7(c) specifies the kinds of securities which may be issued by companies of a registered system. Section 7(c)(1) identifies common stock and first mortgage bonds as the primary means of financing utility systems. The Commission can, however, under section 7(c)(2), authorize other forms of financing. Section 7(d) is concerned with the quality and cost of the securities to be issued and requires the Commission to make specific findings including (1) that the securities be reasonably related to the capital structure of the issuing company and the holding-company system and the earning power of the applicant; (2) that the particular security be appropriate for the economical and efficient operation of the system's business; and (3) that the cost of financing be reasonable. In broad perspective each financing must fit the capital structure of the system and not prejudice future financing. As we have noted, the Commission recognizes that EWGs will not be traditional electric utility companies and so, traditional financial standards will not necessarily apply.

The Commission's review of these transactions should not impose an undue delay on the registered holding companies. The staff has in place a procedure referred to as "budget financing authority," whereby a registered holding company or its subsidiary can seek financing authority from the Commission for an 18-24 month prospective period. Upon approval, the company can access the market with individual security issues as the company deems appropriate during this period. It would appear that in planning the construction and operation of an EWG, like any other construction project, the holding company would be able to approximate the time of its financing needs to take advantage of the staff's budget financing authority, and thereby mitigate any potential delays in securing authorization for an investment in the EWG.

Although the Commission attempts to review all applications in an expeditious manner, inherent in any application filed under the 1935 Act is the risk of delay when comments or requests for hearing are received by the Commission from interested parties. Once the Commission receives a request for hearing, the order can no longer be issued by delegated authority. The matter, with the staff's recommendation, must be presented to the Commission for decision. If the Commission determines that there is a substantial question of fact or law and sets a matter down for hearing, it is impossible, of course, to know if and when an order authorizing the application will issue.

CONCLUSION

Again, thank you for allowing the Commission the opportunity to comment on the proposed legislation. I would be pleased to respond to any questions the Committee may have.

The CHAIRMAN. Thank you very much, Commissioner Fleischman.

Next, we will hear from Linda Stuntz.

STATEMENT OF LINDA G. STUNTZ, DEPUTY UNDER SECRETARY, OFFICE OF POLICY, PLANNING, AND ANALYSIS, DEPARTMENT OF ENERGY

Ms. STUNTZ. Thank you, Mr. Chairman. Good morning and members of the committee.

I am pleased to have this opportunity to present the administration's views on amendment of the Public Utility Holding Company Act. We agree with you that this belongs in the National Energy Strategy and it is a very important legislative proposal.

Both the National Energy Security Act of 1991 and the administration's National Energy Strategy Act would remove PUHCA's barriers to greater competition in the wholesale electricity market. It has not escaped the attention of this committee, I am sure, that important changes are occurring in the electric power industry.

Over the past several years, nonutility sources have supplied over one-third of our new generating capacity and it appears that this fraction will be even larger in the future.

It is no longer necessary for electric utilities to have a monopoly over electricity generation. Nor do all utilities want that monopoly.

Many State regulators are encouraging this trend. Dozens of utilities in 23 States have tried new rules that enable third parties to supply electricity under competitive procurement practices. The consequences of these changes may not be obvious to the average electricity consumer, but we believe they hold great promise.

First, they promise to provide lower cost electricity. Virginia Power, for example, found that outside suppliers could, in some cases, provide electric power at significantly less cost than if the company had produced the power itself. It held one of the first competitive auctions in the Nation.

It was not sure, at all, what the potential response would be. In fact, the respondents offered to sell several times as much power as Virginia Power needed to buy. This gave the utility and its customers a choice. And that is what you talked about in your opening statement, Mr. Chairman. Since that time, Virginia Power's experience has been duplicated repeatedly across the country.

Second, these changes allow electric utilities to economize on capital. In 1989, the Nation invested a total of about $235 billion. The electric utility industry, alone, accounted for about $20 billion or almost 10 percent of this total. The new competitive procurement options will help to insure that the industry uses the Nation's capital efficiently.

Third, and perhaps most importantly, the new competitive procurement practices provide for but do not force, the use of an alternative to traditional cost of service regulation for acquiring electric power capacity. Potentially, this is lower cost but still reliable power for a profit. The availability of this alternative is significant because, as you pointed out, it encourages needed technological innovation.

Under the old rules, innovation is frequently discouraged. Why? Because if the utility develops a better way, if it takes a risk to generate power, the rewards to the utility are strictly limited. If the innovation fails, however, the utility frequently bears much of the risk. It is a "heads, I win, tails, you lose," situation that has dampened innovation and technological ventures in the industry.

Under these new rules of competitive procurement, both consumers and power producers can profit from technological change. It need not be a win/lose. It can be a win/win situation. This encourages engineering and business talent to focus on finding better ways to generate electricity. And it is in this context, we believe, that you must consider PUHCA reform.

A growing degree of competition already exists in the electricity industry. This is not about restructuring the industry. The industry is already becoming restructured. The issue is, who should be allowed to participate in this competition.

Under current rules, many potential, very able suppliers, some of the most able suppliers, are effectively precluded from actively participating in this market. Under the changes that you propose and that are proposed in the administration's legislation, able builders and operators of power plants are not discouraged from competing.

Mr. Chairman, I would like to commend you and your staff for the leadership you have displayed over the past 2 years on this very controversial and complex subject.

Our legislative proposal builds on your work. It differs significantly, to be sure. But I want to make it very clear that we have many elements, also, in common.

Our proposal, like yours, would establish a category of power producer called an exempt wholesale generator, or EWG. This lets both utilities and nonutilities freely enter wholesale power markets by establishing EWG subsidiaries without restriction by Public Utility Holding Company Act regulation.

Where an EWG has a utility affiliate, consumers must be protected, we believe, against cross-subsidy and preferential self-dealing. Our basic approach to protecting consumers is first to follow the lead of the 1935 act and rely on State government protections, confirmed and clarified as our legislation proposes.

And second, to similarly clarify and confirm the pertinent authorities of Federal regulators. We do that in two ways. First, in the administration's bill, a proposed rate for electricity sold by an EWG would not be considered just and reasonable under the Federal Power Act, if that EWG receives undue advantage from an affiliate relationship between the EWG and the purchaser.

Many believe that FERC already has this authority. We believe that, to satisfy the concerns and resolve any doubts, it is appropriate to codify that.

Further, a State commission, to address the purchasing side of the equation as well as the selling side, may disallow recovery of costs determined to be imprudently incurred in a wholesale power purchase, with some exceptions, where the wholesale purchaser has no alternative to accepting the amount of power or cost allocated to it by the FERC.

I will point out, Mr. Chairman, as you suggested, that we oppose giving utilities the ability, as a matter of Federal law, to unilaterally declare that they would not purchase electricity from an exempt wholesale generator for a period of 10 years.

We respect what you are trying to do and appreciate it. We have tried, ourselves, to bridge the seemingly unbridgeable gulf between the two camps on this issue. But with great respect, we believe this provision could, in fact, substantially undermine the very competition you are trying to create, and we are, in this legislation.

I want to conclude by making three points. Number one, PUHCA unnecessarily precludes broader competition in wholesale power markets and is inconsistent with legislation like PURPA, passed much more recently and long since PUHCA was originally enacted. Amending the act to allow broader competition and again, I want to focus on "allow," not "force"—could yield major long-term benefits for electricity consumers.

Two, we believe the key policy challenge for PUHCA amendment is how to reduce the act's barriers to entering the wholesale power market without putting electricity consumers at risk.

The administration's PUHCA reform proposal—informed by a lot of the listening we have done over the last year and a half to NARUC, to State commissioners, to consumer organizations—addresses and meets this challenge by eliminating barriers to entry, while providing effective protection for consumers where needed, without creating or substituting new, elaborate, oversight requirements.

Finally, Mr. Chairman, as I suspect you have well learned in the time you have been dealing with this issue, it is almost as important to understand what these proposals do not do as it is to understand what they do.

Amending PUHCA, as proposed by the administration, would first, not compel utilities or State regulators to abandon traditional utility construction of new generating capacity in favor of competitive procurement. We are not trying to force them to go in one mode or another. We are creating opportunities and choices.

Second, it would not erode State powers to protect the interest of electricity consumers. And third, it would not lead to an erosion of the reliability of electricity service.

To support the proposals presented here today, we have provided the committee with Technical Annex Number 1 of the National Energy Strategy, entitled an Analysis of Options, to Amend the Public Utility Holding Company Act.

This analytical paper was prepared by an interagency group of analysts and staff, in support of the National Energy Strategy development process. I welcome your questions on this controversial, but we believe, very important issue.

Thank you.

[The prepared statement of Ms. Stuntz follows, the attachment has been retained in committee files, only the Executive Summary and Contents has been reprinted:]

STATEMENT

OF

LINDA G. STUNTZ
DEPUTY UNDER SECRETARY
U.S. DEPARTMENT OF ENERGY

CONCERNING

TITLE XV OF S. 341,
PUBLIC UTILITY HOLDING COMPANY ACT REFORM

SUBMITTED TO THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES
U.S. SENATE

MARCH 14, 1991

EXECUTIVE SUMMARY

1. PUHCA serves an important function, but it is an anachronism in many ways. The structure it imposes on the electric utility industry made sense 55 years ago when the Act was passed, but today that structure precludes broad competition in wholesale power markets and is inconsistent with more recently passed legislation. Amending the Act to facilitate such competition could yield major long-term benefits for electricity consumers.

2. The key policy issue for PUHCA amendment is how best to devise procedures to reduce the Act's barriers to wholesale power market entry without putting electricity consumers at risk.

3. The Administration's PUHCA bill would achieve this objective. It eliminates barriers to entry and provides effective protection for consumers where needed--without creating new or elaborate oversight requirements.

4. Amending PUHCA as proposed by the Administration would:

   - Not compel utilities or State regulators to abandon traditional utility construction of new generation capacity in favor of competitive procurement,
   - Not erode State powers to protect the interests of electricity consumers, and
   - Not lead to an erosion of the reliability of electric service.

5. The Administration is opposed to the provision in title XV of S. 341 allowing utilities to unilaterally declare that they would neither purchase electricity from an exempt wholesale generator nor acquire an ownership interest in such an entity for a period of up to ten years.

INTRODUCTION

Good morning, Mr. Chairman and members of the Committee. I am pleased to have this opportunity to present the views of the Administration and the Department of Energy concerning amendment of the Public Utility Holding Company Act of 1935 (PUHCA, or the Act). Both title XV of S. 341, the National Energy Security Act of 1991, and title IV of the Administration's National Energy Strategy Act would remove PUHCA's barriers to competition in wholesale electricity markets. We believe that PUHCA reform is one of the most important elements in these bills.

Much of my testimony deals with technical aspects of public utility law, and these technical details are important. But before I focus on those details, I want to focus on the big--and positive--overall picture.

Important changes are occurring in the electric power industry. Most people are not aware of these changes, but to many watchers of the industry, they hold great promise indeed.

Over the past several years, non-utility sources have supplied over a third of our new generating capacity. It is no longer necessary to give electric utilities a monopoly over electricity generation, nor do all utilities want a monopoly. Many State regulators are encouraging this trend. Dozens of utilities in 23

States have tried new rules of the road that enable third parties to supply electricity under competitive procurement practices.

The consequences of these changes may not be obvious to the average electricity consumer, but here's why they hold great promise.

First, they promise to provide lower-cost electricity. Virginia Power, for example, found that outside suppliers could in some cases provide electric power for significantly less than the company would have paid had it produced the power itself. Virginia Power held one of the first competitive auctions in the Nation for the right to provide new generating capacity by contract. Virginia Power was not sure what the response from potential suppliers would be. The respondents offered to sell several times as much power as Virginia Power needed to buy. That gave the utility and its customers a choice. This utility's experience has since been duplicated repeatedly across the country.

Second, these changes allow electric utilities to economize on capital. In 1989, the Nation invested a total of about $235 billion, and the electric utility industry (including both investor-owned and publicly-owned utilities) accounted for about $20 billion, or about 9 percent of the total. The new competitive procurement practices will help to ensure that the industry uses capital efficiently.

Third and most important, the new competitive procurement practices allow us to move beyond the traditional cost-reimbursement rules for purchasing electric power and into the new rules of lower-cost--but still reliable--power for a profit. That change is significant because it encourages needed technological innovation. Under the old rules, if a utility develops a better way to generate power, all cost reductions belong to the customer. Under the new rules, both customers and business can profit from technological change. That provides the prospect that increased engineering and business talent will be focused on finding better ways to provide power more efficiently. American enterprise can conquer a continent, produce smart weapons, and master the telefax. Changing PUHCA will help focus that talent and ingenuity on finding better ways to generate electricity.

It is in this context that we must consider PUHCA reform. A degree of competition already exists in electricity generation. At issue is: who should participate in the competition? Under current rules, many potential suppliers face strong disincentives against participation in the market. Under the changes proposed in the Johnston bill and in the Administration bill, no competitors are discouraged from competing.

As the Members of this Committee well know, competition ensures good service to customers and incentives to minimize costs. The net effect of these changes and of competition in the marketplace: dynamic change and sound conservation of energy and other resources, increased competitiveness, rising incomes and opportunities. The net beneficiaries of the productive changes: the American people and the American economy.

WHY PUHCA REFORM BELONGS IN THE NATIONAL ENERGY STRATEGY

The portion of our total energy consumption used for the generation of electricity has grown steadily for several decades. In the projections and analyses we prepared for the National Energy Strategy, we found ample reason to expect this trend to continue. By the year 2010, we expect that over 40 percent of total U.S. energy consumption will be used for the generation of electricity, as compared to 36 percent today. Given the rising importance of electricity, finding new ways to produce, distribute, and consume electricity as efficiently and as cleanly as possible will yield significant benefits.

We believe that competition in the wholesale power business can greatly aid the provision of these benefits. When PUHCA was enacted in 1935, competition in wholesale power was not considered feasible. Electricity was produced by local utilities, and the provision of additional generating capacity when needed was presumed to be a responsibility of the local utility. Today, largely because of exemptions from PUHCA authorized in the Public Utility Regulatory Policies Act of 1978 (PURPA), we know that other types of firms can supply reliable and economic electricity to the grid. PUHCA, however, presents serious obstacles to many potential entrants into the business of producing electricity for sale in wholesale markets.

Over the past two decades the cost of constructing new power plants has varied widely, at least in part because of varying abilities of the firms building the plants. The cost per kilowatt for new coal or nuclear plants of the same or similar vintage has differed by factors of two or three (more in some extreme cases). Based on the analyses developed for the National Energy Strategy, we expect that we will need about 200 gigawatts of new generating capacity to meet the electricity requirements of a growing U.S. economy in 2010, even with aggressive conservation and efficiency efforts and assuming that the existing 700 gigawatts of installed capacity is maintained through refurbishment and replacement.

Given this need for substantial amounts of new generation capacity in the decades to come, the public will benefit if we make it possible for the best in the business to compete for the opportunity to supply it.

PUHCA REFORM NEED NOT JEOPARDIZE CONSUMERS OR RELIABILITY

We believe that the Act can be amended to reduce greatly PUHCA's obstacles to competition in wholesale power markets, without putting the interests of consumers at risk, and without adverse effects on the reliability of electric service.

Insofar as reliability of service is concerned, nothing in your or our PUHCA proposals would require anyone to purchase power from anyone at any time. Utilities and State regulators would retain their present ability to determine what new generating capacity will be built by the utility and what capacity will be built by others. To the extent capacity is built by others, a utility would retain the ability to structure power purchase contracts to minimize risks and maximize performance. This issue is discussed at greater length later in this statement.

The question of how to reduce barriers to producers' entry without subjecting consumers to unacceptable risk is, in our view, the most critical issue to be resolved in the formulation of an acceptable bill. We want all potential electricity producers, including corporate relatives of existing utilities (here termed "affiliated power producers," or APPs) to be able to enter this market readily. At the same time, it is clear that APPs involve special problems and risks from the perspective of consumer protection.

If an electric utility or its holding company parent is able to establish an APP for the purpose of producing electricity for sale to itself, consumers and regulators worry that these purchases will be above the market price and that this additional cost will be passed on to the utility's customers. We call this "preferential self-dealing." We wish to be clear that we are not opposed to transactions between EWGs and utility affiliates per se. We oppose transactions between EWGs and utility affiliates only when they adversely affect consumers' interests. Another potential problem involves "cross-subsidies." If a utility establishes an APP for the purpose of producing and selling to others, it is possible that costs or risks that should be borne by the APP will be shifted to the utility and thereby to the utility's customers. A critical challenge in designing PUHCA legislation, we believe, is to address these potential problems effectively without creating cumbersome new regulatory requirements that would limit the very competition we want to enhance.

TITLE XV OF S.341 AND THE ADMINISTRATION'S PUHCA PROPOSAL

Before commenting on title XV and our proposal, Mr. Chairman, I would like to congratulate you and your staff for the leadership you have displayed over the past two years on the subject of

PUHCA reform.

Through your efforts, amendment of PUHCA has ceased to be an arcane topic understood only by a few experts and has become a matter for serious public policy discussion. It is controversial, to be sure, but I am confident that the American public will grasp readily the idea that competition is both feasible and beneficial in the wholesale power business. Further, I am confident that as it becomes apparent that the possibility of competition in wholesale power markets holds large potential benefits for consumers, the problem of protecting consumers against cross-subsidies and preferential self-dealing will be solved.

The Administration's National Energy Strategy Act builds on the foundation you have created. Our PUHCA proposal differs significantly from title XV to be sure, but I want to make it very clear that it has many elements in common with title XV.

Our proposal, like title XV, would establish a category of power producer called an "exempt wholesale generator" or EWG. An EWG is exempt from PUHCA as long as it engages exclusively in the business of producing and selling electricity at wholesale, even if it has one or more corporate relatives that are jurisdictional under PUHCA.

One very important effect of this language is that it would enable non-utility parties to enter wholesale power markets (by establishing EWG subsidiaries) without becoming subject to PUHCA regulation. Because these parties would have no utility affiliates, the core consumer protection issues (preferential self-dealing and cross-subsidy) do not arise.

With respect to EWGs with utility affiliates, our basic approach to protecting consumers against preferential self-dealing and cross-subsidy is to clarify the pertinent authorities of Federal and State regulators.

A proposed rate for electricity sold by an EWG will not be considered just and reasonable under the Federal Power Act if the EWG receives "undue advantage" from an affiliate relationship between the EWG and the purchaser. This provides broad protection against preferential self-dealing through an explicit statutory foundation for the scrutiny that the Federal Energy Regulatory Commission (FERC) has given in its recent cases to APPs seeking approval of rates for sales to utility affiliates.

This Federal authority speaks only to the determination by the FERC of the rate to be charged by the seller; it is silent about the appropriateness of this rate from the perspective of the purchaser. The subsection on State authority addresses the latter concern, and affirms that a State commission may disallow recovery of costs determined to be imprudently incurred in a wholesale power purchase, with some exceptions where the wholesale purchaser has no alternative to accepting the amount of power or costs allocated to it by the FERC.

Thus, a State commission may reject as imprudent costs incurred by a utility purchaser, either because the utility had more attractive alternative sources of supply, or because the utility did not act according to a State-approved integrated resource plan, or for other reasons.

I want to turn now to a step-by-step review of how various categories of potential EWG parents would be affected by the Administration's PUHCA proposal, with particular attention to the provisions for consumer protection. It is useful to think in terms of four categories of prospective EWG parents:

(1) Non-utilities (including non-utility holding companies);
(2) Registered utility holding companies;
(3) Exempt utility holding companies; and
(4) Simple utilities.

I will discuss each category in detail below.

Non-Utilities (Including Non-Utility Holding Companies)

Entities with no affiliates or subsidiaries subject to the Act would be free to establish an EWG without encumbrance under the Act. The EWG *per se* would be free of the Act by definition, and its corporate relatives would remain outside the Act despite the EWG's role as a wholesale electricity producer. Preferential self-dealing and cross-subsidy are not issues here because the EWG's affiliates could not sustain these business practices in a competitive environment. None of them provides monopoly service to captive customers.

Registered Utility Holding Companies

PUHCA does not regulate utilities directly; it regulates "utility holding companies," firms that own significant voting interests in utilities or otherwise control utilities. "Registered" utility holding companies are heavily regulated under PUHCA. There are nine registered electric utility holding companies in the U.S. today, and they own or control about 15 percent of the Nation's generation capacity.

Typically the registered holding company owns or controls one or more "operating utilities," which provide retail electricity service under State regulation. The registered company's operating utilities may be in several States, provided they are operated as an integrated utility system. The system's generation capacity may be centrally owned, or its ownership may be dispersed among the operating utilities. All intersubsidiary transactions except electricity sales are subject to review by the Securities and Exchange Commission (SEC) and are priced at cost unless the SEC grants an exception from this latter requirement. The rates for power sales are determined by the FERC under the Federal Power Act.

Under the Administration's proposal, a registered utility holding company may establish an EWG without hindrance under the Act, provided the EWG does not engage in transactions with a utility affiliate without prior State commission approval. More specifically, the registered company or its utility affiliates may do so only:

> ... so long as the exempt wholesale generator is not a party to a contract, either directly or through an associate company, for the sale of electric energy to an associate company ... that provides electric service to electric consumers, unless each affected State commission has given its prior approval of the contract under State law.

Several aspects of this provision are worth noting. It does not prevent a registered company from establishing an EWG, or prohibit transactions involving the EWG and utility affiliates. Instead, it requires that any contract for such transactions must have the prior approval of each affected State commission. An "affected State commission" is defined in the bill as any State commission that has jurisdiction to regulate a holding company affiliate that provides retail electric service. There may be circumstances in which a transaction between an EWG and a utility affiliate would provide economic benefits. This provision preserves State regulators' authority to approve or reject contracts for such transactions under State law.

If the registered holding company or its utility affiliates were to violate this provision and sign such a contract without State commission prior approval, the registered company would lose its right to operate an EWG without hindrance under the Act. The Act as presently written would then apply, and all transactions and relationships between the EWG and its corporate relatives (including the holding company) would be open to SEC scrutiny.

As in all other cases, in setting a rate for the wholesale power transaction, the FERC could not approve a proposed rate if the seller gains an "undue advantage" from the affiliate relationship.

Exempt Utility Holding Companies

About 46 percent of the Nation's generating capacity is controlled by what are known under the Act as "exempt utility holding companies." These are utility holding companies that have been granted exemptions from the stringent regulation imposed upon the registered holding companies. Exemptions are granted now by the SEC if either of two conditions is met and remains in effect:

(1) The holding company and its subsidiary utility companies are "predominantly intrastate in character." They carry on their business substantially in a single State, in which the holding company and its subsidiary companies are organized [sec. 3(a)(1)].

(2) The holding company is itself a public-utility company whose operations do not extend beyond a group of contiguous States [sec. 3(a)(2)].

Thus, an exempt holding company is either confined to one State, where the State regulators can control it, or the holding company is itself a utility which operates in a contiguous group of States and does not attempt to escape State regulation by forming a non-utility parent company to control its stock. In either case, according to the framers of the Act, there is no need for the stringent Federal regulation imposed on registered companies. Under these provisions, however, acquisition by an exempt company of a distant facility to serve wholesale electricity demand in another State would in most cases lead to a loss of exemption.

Under the Administration's bill, ownership of an EWG would not affect the eligibility of a utility holding company for an exemption under the Act, provided two conditions are met:

(1) The holding company must have an appropriate means for determining the allocation of costs between the EWG and any corporate affiliate that provides retail electric service (so that cross-subsidies can be monitored and corrective action taken if needed); and

(2) The EWG must not be a party to a contract for the direct or indirect sale of electricity to a corporate affiliate that provides retail electric service unless the contract has the prior approval of the State commission (or commissions) that regulate the retail rates of any utility owned by the holding company. That is, a transactions between the EWG and a utility affiliate must be pre-approved by State commissions.

As in the case of the registered companies, this language allows exempt holding companies to own EWGs and does not prohibit transactions between an EWG and utility affiliates. As with the registered companies, it requires the exempt companies to obtain prior approval of any contract for transactions between an EWG and a utility affiliate from each affected State commission in order to remain exempt. Failure to establish adequate means for the State commissions or others to determine the allocation of costs between an EWG and a utility affiliate providing retail service could also lead to loss of exemption.

It is the intent of the Administration's bill that the SEC would terminate the holding company's exemption if these conditions are not met. In exercising this authority, the SEC would be required to consider, among other relevant factors, any views submitted to it by each affected State commission.

There is then direct protection against both preferential self-dealing and cross-subsidy, without establishing elaborate requirements for _ex ante_ review of EWG establishment. Here too a rate for an EWG sale to a utility affiliate could not be approved by the FERC if the EWG received "undue advantage" from an affiliation.

Simple Utilities

A simple utility is a utility that is structured as a single integrated corporation. It is not owned by another company, which would then become a utility holding company under the Act. By avoiding the holding company structure altogether, such a utility is wholly outside PUHCA's jurisdiction, even if it operates in more than one State. About 14 percent of the Nation's generating capacity is currently owned by simple utilities.

Today, a simple utility that is a good power plant builder is virtually blocked from entering distant wholesale power markets without coming under the Act, unless it is willing to do so without creating a subsidiary for that purpose. This would mix the regulated retail business with another business within a single corporation. Such a step would affect the riskiness and liabilities of the retail business, and would likely be unacceptable to the utility's shareholders and regulators. Establishing a subsidiary APP would make it jurisdictional under PUHCA today and could lead to registered-company status and the requirement to operate as an integrated utility system.

Under the Administration's bill, a simple utility would be free to establish an EWG subsidiary without becoming jurisdictional under PUHCA. Further, it would not be prohibited from entering into transactions with its EWG subsidiary. However, the subsidiary seller's rate for such a transaction must be approved by the FERC, where the "undue advantage" clause discussed earlier would apply. Similarly, State authority would determine whether the transaction reflects a prudent buying decision by the utility purchaser. Also, State commissions can check for cross-subsidy between the parent simple utility and the subsidiary EWG, even if the EWG does not sell to its parent. This is easy for State commissions to do if there is no holding company structure to complicate State regulation.

Thus here, as in the previous cases, the Administration's bill provides effective protection for consumers against preferential self-dealing and cross-subsidy between an EWG and an affiliated utility engaged in the provision of retail service.

SUGGESTED CHANGE TO TITLE XV OF S. 341

Let me address a section of title XV which has no counterpart in the Administration's bill. This is section 15003, "Election to Avoid Purchase from or Ownership of EWGs." This section would enable an electric utility upon its own decision to wholly insulate itself from the effects of PUHCA amendment. That is, the utility could declare that for a period of up to ten years, it will neither purchase electricity from an EWG nor acquire an ownership interest in an EWG. This declaration is to be renewable if the utility so desires. State commissions are explicitly prohibited from imposing any direct or indirect penalties upon utilities under their jurisdiction that exercise this option.

This Administration opposes this section because it is unnecessary, impractical, and anticompetitive.

It is unnecessary because PUHCA amendment would not jeopardize existing utilities or their investments. State commissions would not dictate competitive procurement of new capacity if it would result in stranded utility investment.

It is impractical because some competitive procurement may be needed to cope with the obligations placed on utilities and States by PURPA. It would also seek, by Federal law, to remove from State jurisdiction matters that are fundamental to electricity supply regulation.

It is anticompetitive because it would allow a regulated monopoly to decide to deny consumers the benefit of greater competition in wholesale power supply. I urge that this section be dropped from title XV.

IMPACTS OF PUHCA AMENDMENT ON RELIABILITY OF ELECTRIC SERVICE

Opponents of PUHCA amendment assert that the legislation would have serious adverse effects on electric service reliability, and I want to discuss this subject in some detail.

Any possible impacts of PUHCA amendment on service reliability would result from adverse effects on either generation reliability or transmission reliability. Let me address each of these in turn.

Impacts upon Reliability or Adequacy of Generation

Some oppose PUHCA amendment on the grounds that there is a risk of utilities becoming overly dependent upon electricity producers who: (1) have no track record; and (2) whose economic competitiveness is illusory because it is linked to the availability of low-cost fuels, tax breaks, favorable financing, or other conditions that can change quickly. These opponents contend that power from these producers could become unavailable to the purchasing utility with little or no notice, to the detriment of reliable and economic service.

But this need not happen at all. Entry into long-term power purchase contracts is voluntary, and maintaining a balanced and diversified mix of generation capacity will remain a primary responsibility of the purchasing utility and its State regulators. For the opponents' line of argument to be tenable, either the purchasing utility would have to enter into contracts that should be rejected, or it would have to be induced to enter such contracts by regulators.

The critics of PUHCA amendment acknowledge that they are concerned about being pressed by regulators to "buy--and buy cheap--rather than build." They cite experiences under PURPA in some States as all too real examples of how utilities can be forced to enter into uneconomic or otherwise undesirable contracts with non-utility power producers.

I regard these past experiences as transitory and not indicative of circumstances today or in the future. Experience has shown that setting PURPA's "avoided cost" administratively is difficult and risky; some States and utilities have found that a competitive process has distinct advantages and have switched to the latter approach. Regulators and utilities have learned that purchased capacity must be dispatchable if it is to be integrated easily into a utility's operations, just as a utility's own generation would be. Early contracts under PURPA did not stress the value of dispatchability. Now such emphasis is common.

Insofar as "leveraging" is concerned, amendment of PUHCA would have no direct effect on the financing of new generation units. A utility would not be required to purchase new electricity supplies from other parties unless its State regulators institute a competitive purchase program and offers are made that the utility and its regulators find attractive. If they do, purchasing utilities, under the guidance of their regulators, can develop procurement contracts that specify limits if appropriate on the independents' use of leveraging.

Impacts upon Reliability of Transmission Network

Some opponents of PUHCA amendment have stressed the interdependent nature of an electric generation, transmission, and distribution system, and assert that increased dependence on power purchased from wholesale producers will erode the reliability of the transmission network.

PUHCA amendment itself would have no direct effect on transmission reliability. The increased competition permitted by PUHCA amendment could affect reliability, but any such effects should be manageable, given the following considerations:

(a) Utilities will continue to have direct control over access to their transmission facilities by non-utility producers. It is common practice now to make a contract between a purchasing utility and a "qualifying facility" (QF) under (PURPA) contingent upon the QF's agreement to operate according to the transmission control center's ground rules. Such ground rules will continue to be set by utilities working jointly through the regional councils of the North American Electric Reliability Council (NERC). Utilities will have ample opportunity to ensure that wholesale electricity trade does not evolve in ways that compromise reliability.

(b) In 1989, the Office of Technology Assessment completed a major study of the technological aspects of increasing competition in the electric utility industry.[1] The study concluded that there are no major *technical* obstacles to maintaining reliability in a competitive wholesale power market. However, the report stressed that competition raises many new uncertainties, and that it would have to be implemented carefully in order to maintain the level of coordination required to preserve reliability.

(c) Utilities which purchase significant quantities of electricity from QFs have testified that such purchases have not led to transmission reliability problems.

Mr. Chairman, that concludes my statement. To provide further support for the arguments presented here, I am attaching an analysis which we are releasing today as *Technical Annex No. 2* of the National Energy Strategy (NES). This analysis, which was prepared as part of the NES process, is subtitled *Analysis of Options to Amend the Public Utility Holding Company Act.*

I would be happy to respond to any questions you or other Members of the Committee may have.

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[1] *Electric Power Wheeling and Dealing: Technological Considerations for Increasing Competition* (Congress of the United States: Office of Technology Assessment, OTA-E-409, May 1989.)

PREPUBLICATION COPY

NATIONAL ENERGY STRATEGY

TECHNICAL ANNEX NO. 1:

ANALYSIS OF OPTIONS TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

First in a series of technical papers developed to support the
National Energy Strategy
First Edition
1991/1992

Executive Summary

The Issue: Should the Public Utility Holding Company Act Be Amended to Enhance Competition in Wholesale Electricity Markets?

Some parties, including some utilities, contend that the Public Utility Holding Company Act (PUHCA, or the Act) should be amended to facilitate competition, reduce the cost of new generating capacity, and enable market forces to play a larger role in guiding the evolution of the industry. Other utilities contend that "nothing is broken" and that amendment of PUHCA could destroy the reliability of electricity service. Some State regulators are concerned that modification of PUHCA could erode their authorities and transfer many of their responsibilities to the Federal Energy Regulatory Commission (FERC), with unknown or adverse implications for electricity consumers. Consumer advocates are concerned that amendment of PUHCA could lead to a recurrence of the abuses of competition which moved the Congress to enact PUHCA in 1935.

In the five decades since its enactment, PUHCA has profoundly affected both the structure of the electric utility industry and the evolution of Federal and State regulation of the electricity sector. It has facilitated effective State and Federal regulation in the electricity sector by forcing utilities and their holding company parents to structure their affairs in one of three ways:

- o Confine themselves to "predominantly intrastate" operations;
- o Adopt a simple single-corporation structure (no holding company parent, no subsidiaries); or
- o Operate as an interstate holding company with single-State utility subsidiaries--that is, as a "registered holding company" subject to stringent regulation by the Securities and Exchange Commission (SEC).

Competition among wholesale electricity producers on a regional or interregional scale was not considered feasible when the Act was passed. Since the enactment in 1978 of the Public Utility Regulatory Policies Act (PURPA), however, competition of limited scope has emerged, suggesting that broad competition in wholesale generation may be feasible, practical, and beneficial to the public. Under PURPA, competitive suppliers are exempt from PUHCA but limited to use of a narrow range of generation technologies, and utilities are limited to less than 50 percent ownership of "qualifying facilities" (QFs).

Broad competition in wholesale generation markets (i.e., open to any firm, using any fuel and any generation technology) is blocked by PUHCA. The Act prevents or inhibits most categories of utilities from entering such markets, either by requiring that a utility's assets must be operated as a single integrated system, or by requiring that the utility become a registered holding company and accept concomitant regulatory burdens. Non-utility firms are inhibited because even partial ownership of generating facilities could make them a "utility holding company" under the Act, and under certain conditions they could be required to divest themselves of businesses not functionally related to the provision of electricity service. Thus under the design implicit in the Act, development of new electric generating capacity is left primarily to the local utility. Today, however, the local utility is not necessarily the most efficient supplier available.

A principal benefit of PUHCA amendment is likely to be lower capital costs for new generating capacity, leading to lower costs for consumers. However, other economic benefits are believed likely, including:

- Use of a wider range of generation technologies, where economic
- Improved operating efficiencies
- Benefits from unanticipated innovations through competition
- More effective mitigation of economic risks associated with construction of new generating capacity
- Macroeconomic benefits of lower electricity prices
- Reduced oil use for electricity generation
- Enhanced export of goods and services by U.S. utility-related firms.

The principal risk associated with PUHCA amendment is that abuses of competition could occur between utilities and their affiliates, depending upon the changes made to the Act, and the degree of competition which would emerge. Several options for consideration in the NES are listed in Table ES-1.

Benefit/Cost Analysis

As an integral part of the National Energy Strategy (NES) process, a benefit-cost analysis has been prepared for each NES option. A definitive benefit-cost analysis for PUHCA amendment is not possible for several reasons, including the fact that the Act can be amended in various ways with different consequences. In order to be responsive to the call for such analysis, the authors estimated the minimum likely benefit and the maximum likely cost. If the ratio of this benefit to this cost exceeds one, PUHCA amendment merits serious consideration.

The benefit/cost analysis was focused on Option II-b. The only benefit estimated quantitatively is an expected reduction in the capital cost for new generation capacity. Using extremely limited data, the minimum benefit is estimated to vary between $300 million and $1.8 billion per year by the year 2000, depending upon the fraction of new capacity needs which would be procured competitively. The present value of this stream of benefits over the 1991-2000 period, discounted at 10 percent per year, varies from $871 million to $5.226 billion.

On the cost side, it is assumed that the current level of regulatory effectiveness could be sustained or increased after PUHCA amendment through increased regulatory oversight. Specifically, it is assumed that Federal and State regulatory agencies would add a total of 250 permanent new staff, at a total cost of $25 million/year ($100,000/position). Additional costs associated with industry compliance are assumed to be an additional $25 million per year. Thus the total costs of PUHCA amendment are estimated to be about $50 million per year for the period 1991 through 2000. The present value of this stream of costs, discounted at 10 percent per year, is $307 million.

The benefit/cost ratio ranges from 2.84 to 17.02, depending on the fraction of new generating capacity procured competitively.

TABLE ES-1

OPTIONS CONCERNING PUHCA FOR CONSIDERATION IN THE NATIONAL ENERGY STRATEGY

Question I: Should PUHCA be amended? Three options are:

Option I-a:	Leave PUHCA unchanged. Make no effort in the NES to broaden competition in wholesale power markets. Conclude that whether utilities buy or build new generation capacity is best left to State regulators and utility managers.
Option I-b:	Leave PUHCA unchanged. Promote broader competition in wholesale power markets through administrative actions within PUHCA's framework.
Option I-c:	Propose or support legislation to amend PUHCA.

Question II:	**If PUHCA should be amended, what should be the focus of the legislation?** Three options are:
Option II-a:	Propose/support amendment of PUHCA, but ease PUHCA's constraints only where consumers would be protected by market forces.
Option II-b:	Propose/support amendment of PUHCA, but protect consumers administratively where market forces are insufficient to prevent possible abuses.
Option II-c:	Propose/support amendment of PUHCA to suspend its requirements for all generation-only entrants into wholesale electricity markets (as proposed in Senator Johnston's "Competitive Wholesale Electric Generation Act of 1989").

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The **Chairman**. Thank you very much, Ms. Stuntz.

Ms. Marlette.

STATEMENT OF CYNTHIA A. MARLETTE, ASSOCIATE GENERAL COUNSEL FOR HYDROELECTRIC AND ELECTRIC, FEDERAL ENERGY REGULATORY COMMISSION

Ms. **Marlette**. Mr. Chairman and members of the committee, thank you for the opportunity to be here today. I am here as a staff witness, and I do not speak for members of the FERC.

Today's electric utility industry clearly is not the industry that existed 10 years ago or even 5 years ago. In 1978, Congress injected a competitive element into the generation sector of the electric industry by creating qualifying facilities under PURPA.

Today, that element has widened and other nontraditional generators are seeking to compete to supply the Nation's power needs. We are also seeing traditional utilities seeking to find new ways in which they can compete.

There is, however, a major barrier to the continued evolution of competition in the electric industry, and that is the Public Utility Holding Company Act. PUHCA is not a complete bar to nontraditional generators entering the market or to competitive generation. And in the past several years, the FERC has addressed over 30 proposals for market-based rates and flexible, non-rate regulation from a number of nontraditional entities, including independent power producers, affiliated power producers, power brokers and marketers, as well as traditional utilities.

It is clear, though, that in many cases, the investors that want to build these new facilities have to go through contorted ownership mechanisms in order to get around the restrictions of PUHCA.

Existing utilities already subject to PUHCA or having obtained an exemption from PUHCA, are constrained as to where they can build new plants. Simply put, PUHCA discourages nonutility firms with technical, engineering and other expertise from entering generation supply markets. And it also inhibits existing, experienced utilities from expanding into other than local markets.

Both S. 341 and the administration's NES proposal, by creating another entity called an exempt wholesale generator, would allow but not mandate a broader range of these entities to compete. This, in turn, would allow competitive markets to develop reliable, more efficient, and lower cost electricity. And it would also spur technological innovation.

I have made a number of general and technical comments in my written testimony which has been submitted, and I will not go into those now. But I do have two major points that I would like to make with you today concerning PUHCA amendment.

First of all, the entities that would be allowed to own EWG's or become EWG's would not be exempt from regulation. The vast majority of these entities would continue to be regulated by the FERC because their rates would be for wholesale sales in interstate commerce.

While the FERC, in many instances, has allowed market-based regulation and flexible nonrate regulation, it has done so only after thoroughly analyzing the market power of these entities and the potential for affiliate or other abuses that could influence the rate paid by purchasers.

There has been a great deal of discussion about the Commission's ability to monitor and to prevent affiliate and other abuses of market power by new entrants, such as exempt wholesale generators.

There have been legitimate concerns raised about cross subsidization, self-dealing, collusion, other types of abuses. I cannot over-emphasize that the Commission has not only the authority, but the statutory mandate, to protect consumers against excessive rates, against undue discrimination, and undue preference.

The CHAIRMAN. Let me stop you right there. Ms. Stuntz just said that while she believes you have that power, you ought to put in a provision that makes it very clear. You think it is very clear?

Ms. MARLETTE. I think we clearly have that authority. I do not think it would hurt to clarify that authority. The statute, itself, does not mention the word affiliate. But I personally cannot imagine a court upholding a Commission decision which allows affiliate abuses to take place to the harm of consumers.

I do not think either the S. 341 or the NES proposal will change the mandate that the Commission currently has to protect.

As I have discussed in my written testimony, the Commission has taken a very tough stand on affiliate abuse issues. And it has stated that it is essential that affiliate transactions be above suspicion in order to insure that markets are not distorted, and in order to insure that franchised utilities not be able to divert profits from their native load ratepayers to the shareholders of newly created EWG's.

The Commission has not hesitated to deny market-based rates in a number of cases involving affiliate transactions and it also has not hesitated to impose conditions, monitoring and reporting requirements to protect against future potential abuses.

I would also point out that the Commission has pervasive accounting authority over public utilities, as well as those who are controlled by or who control the public utilities. And that would not change.

The second major point I would like to make concerns reliability, and the ability of these nontraditional generators to supply reliable service.

Some have argued that nontraditional generators will be unreliable because they do not have proven track records, they have economic incentives only, and they have no obligation to serve consumers.

The nontraditional facilities which have been presented to the Commission in the past few years, however, have primarily, are primarily, being built and developed by entities that do have extensive technological, engineering and generation expertise.

These entities include companies such as Bechtel, General Electric, Westinghouse, affiliates of Southern California Edison, New England Electric System, Long Lake Energy—a big QF developer—just to name a few. These are clearly entities that have expertise in building and operating reliable plants.

Another critical point concerning EWG purchases and reliability, as Linda stated, is that these purchases would be voluntary. A prudent utility will not buy, I do not believe, from an unreliable power source. It will not consider price alone, but it will consider nonprice factors as well.

Moreover, a number of purchasers already rely on third party suppliers to meet their needs. And they are able to construct contracts to reduce the risks to their consumers. We have seen at the Commission in the past few years a number of contractual provisions, for example, by retaining the right to overtake the plant if the owner becomes insolvent. Parties can limit exposure to any one fuel source, developer or supply. They can also retain the right not to pay the plant owner if the plant is not operable.

The contracts we have reviewed, so far, do contain these types of provisions and States and their local utilities can continue to insure adequate consumer protection in so far as reliability is concerned.

In conclusion, both the S. 341 and the NES proposal reforms, I believe, would be major steps toward revitalizing the electric industry to develop more supply options to meet consumer needs.

The Public Utility Holding Company Act served a useful purpose in breaking up and restructuring an industry that was full of abuses in the 1920's and 1930's. However, in the subsequent 55 years, as I stated earlier, the industry has changed dramatically and the statute, as enacted, is a severe barrier to developing more efficient, technologically innovative and reliable generating capacity.

The amendment of PUHCA would not change FERC regulation. It would not change State regulatory protections. It would leave intact a voluntary system of utility generation planning.

We believe that the amendments will harness the competitive forces that are already in place, that are already happening, and have emerged since PURPA, and that they will enhance the reliable electric supply system on which we have come to depend. We would urge that PUHCA reform be part of any energy legislation package that Congress enacts.

Thank you very much.

[The prepared statement of Ms. Marlette follows:]

STATEMENT OF CYNTHIA A. MARLETTE
ASSOCIATE GENERAL COUNSEL FOR
HYDROELECTRIC AND ELECTRIC
FEDERAL ENERGY REGULATORY COMMISSION
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

MARCH 14, 1991

Mr. Chairman and members of the Committee, I am pleased to be here this morning to discuss the Public Utility Holding Company Act amendments proposed in Title XV of S. 341, the National Energy Security Act of 1991, and in Title IV of the Administration's National Energy Strategy Act.

My name is Cynthia A. Marlette, and I am Associate General Counsel for Hydroelectric and Electric at the Federal Energy Regulatory Commission. I am appearing before you today as a staff witness and do not speak for members of the Commission.

S. 341: The National Energy Security Act of 1991

S. 341 would remove a major barrier to increased competition in the electric utility industry by creating a new corporate entity known as an exempt wholesale generator (EWG). An EWG, which could engage only in the business of owning or operating facilities used for wholesale sales of electric energy, and selling such energy, would not be deemed an "electric utility company" under the Public Utility Holding Company Act of 1935 (PUHCA) and would be exempt from all provisions of the Act. S. 341 would allow both non-traditional entities and traditional franchised utilities to own EWGs.

The entities that would qualify for EWG status would be non-traditional wholesale power suppliers, that is, power suppliers that do not have franchise service obligations. These suppliers are not a new phenomenon. Over a decade ago Congress gave the FERC authority under the Public Utility Regulatory Policies Act of 1978 (PURPA) to exempt one group of non-traditional power suppliers -- qualifying facilities (QFs) -- from PUHCA as well as the Federal Power Act and most state regulation. Qualifying facilities, however, are not the only non-traditional power producers that have the ability to add significantly to the

Nation's supply needs. Indeed, as discussed in Enclosure A of this testimony, the Federal Energy Regulatory Commission (FERC or Commission) in recent years has entertained a growing number of market-based rate proposals from entities many of whom would fall within the EWG definition of S. 341. These entities include independent power producers (those having no affiliation with traditional franchised utilities) and affiliated power producers (those affiliated with traditional franchised utilities). These entities do not meet the restrictions for qualifying status under PURPA, yet in most instances they lack market power over the purchasers to whom they sell.

At the outset, it should be emphasized that amending PUHCA -- whether through Title XV of S. 341 or through Title IV of the National Energy Strategy Act -- would allow, but not mandate, a broader range of these entities to compete in building new wholesale generators. This, in turn, would allow markets to develop reliable, more efficient, lower cost electricity. Although the cases presented to the Commission thus far indicate that PUHCA is not an absolute bar to the development of power plants by independent and affiliated power producers, it is clear that investors have to devise contorted ownership mechanisms in order not to become subject to PUHCA. Many will have to reconfigure their ownership structures prior to power flowing from the new facility. In short, PUHCA restrictions discourage non-utility firms with technical, engineering, or other expertise from entering competitive generating markets, and also inhibit existing experienced utilities from expanding into other markets.

Unlike most non-traditional qualifying facilities under PURPA, EWGs would not be exempt from FERC regulation. Because EWGs must engage exclusively in owning or operating facilities used for wholesale sales, and most wholesale sales are in interstate commerce, most EWGs would be regulated as public utilities under the Federal Power Act (FPA). Despite statements to the contrary, non-traditional generators engaging in wholesale sales (other than most QFs) are not non-utility generators, nor are they non-regulated generators. While the FERC in many instances has applied a different type of regulation to non-traditional generators-- by allowing market-based rates and granting certain regulatory waivers-- it has done so only after thoroughly scrutinizing the market power of the entity involved and the potential for affiliate or other abuses that could influence the rate paid by the purchaser.

In several instances, as discussed in Enclosure A, the Commission has refused to grant market-based rate regulation to non-traditional generators. In addition, even where flexible rate and non-rate regulation have been allowed, the Commission has, where necessary, required monitoring and/or reporting requirements to prevent potential future abuses or adverse effects on the public interest. S. 341 would not change the Commission's jurisdiction or statutory responsibilities regarding regulation of EWGs.

There has been a great deal of discussion about the Commission's ability to monitor and prevent affiliate and other abuses of new market entrants such as EWGs. It cannot be overemphasized that the Commission has not only the authority but the statutory mandate under the FPA to assure that purchasers are protected from excessive rates, undue preference and undue discrimination. As discussed in Enclosure A, the Commission has taken a tough stand on affiliate abuse issues and has recently enunciated a strict test for affiliate transactions which may affect pricing to non-affiliates. The Commission has stated that it is essential that affiliate transactions be above suspicion in order to ensure that the market is not distorted, and that franchised utilities not be able to divert benefits away from their native load ratepayers to the shareholders of newly created entities requesting market-based rates.

While S. 341 generally would benefit consumers by allowing a broader range of firms to compete to supply electricity at the wholesale level, there is one provision contained in the legislation which could seriously harm consumers. Importantly, S. 341 does not mandate anyone to purchase EWG power. However, Section 15003 of S. 341 would allow an electric utility to refuse to purchase such power even where it might be the most reliable, least-cost alternative available to serve that utility's customers. Section 15003 allows electric utilities to elect to avoid purchasing from EWGs and precludes state regulatory penalties of any kind if utilities, in their sole discretion, make this election. As discussed in more detail below, this provision would shield utilities from imprudent actions, and could cast on consumers the burden of paying for more costly electricity than they otherwise might have to pay.

A final general comment regarding EWGs concerns their ability to provide reliable service. Some have argued that non-traditional generators will be unreliable because they have no proven track record, have only economic incentives, and have no obligation to serve consumers. The non-traditional facilities presented to the Commission in the past few years, however, primarily are being built and developed by entities that do indeed have "proven track records." These include companies such as Bechtel, General Electric, Westinghouse, and affiliates of Southern California Edison Company, Long Lake Energy, and New England Electric System, to name a few. These clearly are entities with extensive expertise in building and operating reliable power plants.

A critical point is that EWG purchases would be voluntary, and that prudent purchasers will not purchase based on price alone but will also consider non-price factors such as reliability. Moreover, many purchasers already rely on third-party suppliers to meet their needs, and they can and do structure contracts to reduce risks (e.g., by retaining the right to purchase the facility if the owner becomes insolvent; by limiting exposure to any one project, fuel source, or developer; and by retaining the right not to pay the seller whenever the plant is not operable). The contracts reviewed by the Commission thus far contain these types of provisions, and states and their local utilities can continue to ensure adequate consumer protections regarding reliability.

In addition to these general comments, there are a number of other technical comments discussed in the following section-by-section analysis of S. 341.

Section 15001: Exempt Wholesale Generators

Section 15001(a)(1) of S. 341 defines an exempt wholesale generator as any person engaged "exclusively in the business of owning or operating all or part of one or more eligible facilities and selling electric energy at wholesale." This would appear to mean that a person may qualify as an EWG only if it owns an eligible facility and sells electric energy at wholesale, or if it operates an eligible facility and sells electric energy at wholesale. However, there may be situations where a person wants to own an eligible facility but not be the person that sells the electric energy from the facility. Likewise, a person may operate an eligible facility but not be the person selling the electric energy from the facility. The wording of Section 15001(a)(1) appears to preclude these entities from qualifying for EWG status. If the intent of the provision is not to preclude these situations, then it is suggested that it be revised.

One possible revision in this regard would be to change the language such that an exempt wholesale generator would be any person engaged "exclusively in the business of owning and/or operating all or part of one or more eligible facilities, and/or selling electric energy at wholesale from eligible facilities." (Underlining represents suggested word changes.)

This type of provision would allow entities to be exempt from PUHCA only if they own and/or operate, and/or sell power from eligible facilities. It should be noted, however, that this would preclude EWGs from engaging in other types of wholesale sales, such as the purchase and re-sale of third-party energy that does not come from eligible facilities.

Section 15001(a)(3) provides that as of the date of enactment of S. 341, if a rate or charge for, or in connection with, the construction of a facility, or for electric energy produced by a facility, was in effect under the laws of any State, then consent with respect to such facility shall be required from any State Commission having jurisdiction over such rate or charge. It would be helpful to clarify that this refers to "consent to become an eligible facility under subsection (a)(2)."

Section 15001(e) provides that the Securities and Exchange Commission (SEC) will retain jurisdiction over certain specific activities involving an exempt wholesale generator and a registered holding company or its affiliates or associates, including "the creation or maintenance of any other relationship in addition to those described in subsection (d)." Because the words "any other relationship" could be construed to include rate agreements for the sale of electric energy between EWGs and their affiliates or associates, and because such wholesale rate transactions in most cases would be within the FERC's exclusive rate jurisdiction, it is suggested that the language be changed to "any other relationship (excluding the sale of electric energy at wholesale in interstate commerce)... ." (Underlining represents suggested word changes.)

Section 15002: Ownership of Exempt Wholesale Generators and Qualifying Facilities

Section 15002 would allow owners of qualifying facilities under PURPA to also own EWGs without losing their QF status. This issue has arisen at the Commission in the context of owners of QFs seeking to own IPPs without losing their QF status. This is a very important clarification which will resolve numerous potential problems on this ownership issue.

Section 15003: Election to Avoid Purchase From or Ownership of EWGs

Section 15003 provides utilities the ability to elect in perpetuity (via 10-year increments) not to purchase from EWGs, and for the most part to be shielded from accountability even if such election were imprudent. The effect of this election provision is to allow utilities to foreclose potential competition that might otherwise provide their ratepayers with more efficient, lower cost power.

This provision restricts the authority of state regulatory commissions to hold their utilities accountable for imprudent actions. To the extent electing utilities sell energy at wholesale, the FERC would be able to find them imprudent for refusing to buy from EWGs and adjust wholesale rates accordingly. The states, however, who have approximately 90 percent of the electric rate jurisdiction in the country, would be precluded under Section 15003(c) from imposing any penalty, directly or indirectly, for imprudent actions. This would shield most utilities from imprudent actions.

Although Section 15003(d) would preclude electing utilities and their affiliates or associates from acquiring or owning an interest in an EWG during the period they elect not to purchase from EWGs, as a matter of policy this would not counterbalance the potential anticompetitive effects and potential harm to consumers that would result.

Section 15003(a) provides that a declaration of intention not to purchase from EWGs must be filed with the FERC. Section 15003(e) provides that violation of any prohibition of the section (e.g., purchasing from or acquiring EWGs during the period of the declaration) shall constitute a violation of the FPA, and the FPA enforcement and penalty provisions shall apply. (The legislation specifically mentions only Section 314 (enforcement) of the FPA, but presumably Section 316 (general penalties) is intended to apply.) As a general matter, it is unclear why the FERC would be given enforcement and penalty authority since in fact the violations would be violations of PUHCA, not the FPA, and the SEC has penalty authority under Section 29 of PUHCA.

Section 15003(e)(2) further provides that for purposes of enforcing the prohibitions in the section, a State commission will be deemed a "person" under section 314 of the FPA. The effect of this provision is to have the FERC policing states and bringing actions against states who violate the Section 15003(c) prohibition that they not penalize electric utility companies who elect not to purchase from EWGs. This provision would present a complex and difficult policing responsibility that possibly could deteriorate state-federal relations in an area where complementary state/federal roles are essential to take full advantage of the potential power supply EWGs may offer.

A final issue raised by Section 15003, which the Committee may want to examine, is that conceivably the section could be interpreted as allowing electric utilities to elect not to purchase from qualifying facilities under PURPA. Most QFs would also qualify as EWGs. PURPA mandates that electric utilities offer to purchase energy from QFs. S. 341 does not mandate purchases from EWGs. However, the 15003 provision could be interpreted to allow utilities to elect not to purchase from anyone who qualifies as an EWG. This is in clear conflict with PURPA, and presumably was not the intent of the drafters. It is suggested that this be clarified.

Section 15004: Preservation of State Authority

Section 15004 clarifies that nothing in Title XV of S. 341 preempts or restricts the authority of states to exercise their authority under current State and Federal law to examine the prudence of EWG purchases by utilities subject to their jurisdiction. This appears to codify existing law as contained in Pike County Light & Power Co. v. Pennsylvania Public Utility Comm'n, 465 A.2d 735 (1983); Nantahala Power & Light Co. v. Thornburg, 106 S.Ct. 2349 (1986); Mississippi Power & Light Co. v. Mississippi ex rel. Moore, 108 S.Ct. 2428 (1988); and Kentucky West Virginia Gas Co. v. Pennsylvania Public Utility Comm'n, 837 F.2d 600 (3d Cir. 1988), cert. denied, 109 S.Ct. 365 (1988).

In our view, states do and should have "Pike County" prudence review authority except where such authority interferes or conflicts with the FERC's exclusive authority over interstate wholesale rates and the resultant impact on national interests. In the majority of cases, State authority does not interfere in this way.

The National Energy Strategy Act Proposal

Since the time the hearing on S. 341 was scheduled, the Administration released proposed legislation, entitled the National Energy Strategy Act (NESA), that would also amend PUHCA. Similar to Title XV of S. 341, Title IV of NESA would remove a major barrier to increased competition in the electric utility industry. Furthermore, as a general matter, the NESA proposal addresses consumer protection backstops more formally than does S. 341. In our view, under current law the Commission and states have adequate authority to protect consumers if PUHCA is amended. Some of the NESA consumer protections, however, would clarify existing authority and may provide further comfort to those who have raised legitimate concerns, particularly regarding potential affiliate abuse by owners of EWGs.

There are several similarities in the NESA proposal and S. 341, and, to that extent, the earlier comments contained herein on S. 341 (both general and technical comments) also apply to the NESA proposed legislation and will not be repeated here. However, there are additional technical comments discussed below on some of the NESA sections which differ from those in S. 341.

NESA Section 401: Definitions

Section 401(2) defines "eligible facility" generally as a facility used for the generation of electric energy exclusively for sale at wholesale. It also states that a "facility" includes a portion of a facility. However, it further provides that "this term" (which would appear to modify the term being defined i.e., "eligible facility") does not include a facility if a rate or a charge for or in connection with the construction or electricity produced by the facility is in effect under the laws of any State.

It is clear under the definition that an entire facility can become an eligible facility, or that a facility can be divided such that one portion is used as an eligible facility and the other portion is used for traditional wholesale sales, as long as neither portion has any retail rate in effect as to that portion. It is not clear, however, whether a facility can be divided such that one portion is used as an eligible facility and the other portion is used for retail sales (under state rate jurisdiction) or is used for partial retail and partial wholesale sales (involving both state and FERC rate jurisdiction). The literal reading of the provision would appear to preclude a portion of a facility from becoming an EWG if any of the remaining portion of the facility has any retail rate attached to it. If this is not the intent of the provision, it is suggested that it be revised.

NESA Section 402: Exempt Wholesale Generators

S. 341 (Section 15001(c)) would allow any holding company exempt under Section 3 of PUHCA to own EWGs or maintain an interest in EWGs, notwithstanding other provisions of PUHCA. NESA Section 402(b), on the other hand, would allow holding companies exempt under Section 3(a) of PUHCA to own or be affiliated or associated with EWGs unless the SEC, upon application of an affected State commission or other interested party, issues an order terminating the exemption because: (1) the holding company has not established appropriate means to allocate costs between the EWG and affiliate, associate or subsidiary companies that provide retail service, or (2) the EWG is a party to a contract, either directly or through associate companies, for the sale of energy to any affiliate, associate or subsidiary company that sells to retail consumers, without each affected State having given prior approval of the contract under State law.

As a general matter, this provision provides a complaint mechanism at the SEC to ensure continued protection against cross-subsidization and self-dealing among affiliates, associates and subsidiaries of exempt holding companies. There are several technical comments regarding the provision.

First, any "interested party" may file an application with the SEC to revoke an exemption. This is an extremely broad category and it may be more appropriate to allow any "affected party" to file such applications.

Second, if an application is filed, the provision allows the SEC to determine the appropriate means of cost allocation between the EWG and the affiliate, associate or subsidiary providing retail service. Many of these affiliates, associates and subsidiaries will be providing both retail and wholesale service. With due deference to the SEC, cost allocation issues are more appropriately a matter of State and FERC expertise under the FPA and appropriate state utility regulation.

Third, the SEC would have authority to revoke an exemption if it determines that there are contracts directly between EWGs, or indirectly through their associates, for sales of electricity to other associates, affiliates or subsidiaries that provide retail service, without each affected State commission having given approval of the contract under State law. This provision is confusing. An EWG can only enter wholesale contracts. An EWG's wholesale contracts, even to entities that provide retail as well as wholesale service, would be regulated by the FERC. The provision may need to clarify that states would not be able to approve wholesale contracts under the exclusive jurisdiction of the FERC.

Fourth, Section 402(c) defines an "affected State commission" as any State commission having jurisdiction to regulate a holding company's associates, affiliates or subsidiaries that provide retail service. This would appear to encompass more than just rate commissions and, for example, would include entities such as the California Energy Commission that regulate siting. If this is not the intent of the legislation, it could be clarified by having the authority apply to "any State commission that has jurisdiction to regulate the retail rates of a holding company's associate company, . . ."

Fifth, Section 402(d) also refers to approvals of contracts by State commissions "under State law." This should be clarified that it does not involve interstate contracts subject to exclusive FERC jurisdiction.

NESA Section 404: Federal and State Authorities

Section 404(a), while not amending the FPA, states that an interstate wholesale rate charged by an EWG is not considered just and reasonable under Sections 205 and 206 of the FPA if the rate allows EWGs "to receive undue advantage" from the existence of an affiliate relationship between the EWG and the purchaser of the electric energy. This would appear to re-state existing law in the FPA, but would highlight specific concerns regarding affiliate relationships (affiliate relationships are not specifically referred to in the current FPA). However, while it certainly does not hurt to clarify existing law, it is suggested that a more accurate wording would be to disallow a rate which allows EWGs "to receive any undue preference" from an affiliate relationship with its purchaser. This wording is consistent with existing FPA terminology as interpreted by the courts and would avoid new interpretations and litigation over what is an "undue advantage" versus an "undue preference."

Section 404(b) attempts to codify existing case law regarding the circumstances under which a state can disallow FERC-approved wholesale costs from being recovered in retail rates by the wholesale purchaser (the so-called "Pike County doctrine"). As a general matter, it is extremely difficult to try to codify case law in this area because the law will turn on the specific facts of each case. We interpret this provision as attempting to codify existing case law as contained in Pike County Light & Power Co. v. Pennsylvania Public Utility Comm'n, 465 A.2d 735 (1983); Nantahala Power & Light Co. v. Thornburg, 106 S.Ct. 2349 (1986); Mississippi Power & Light Co. v. Mississippi ex rel. Moore, 108 S.Ct. 2428 (1988); and Kentucky

West Virginia Gas Co. v. Pennsylvania Public Utility Comm'n, 837 F.2d 600 (3d Cir. 1988), cert. denied, 109 S.Ct. 365 (1988).

There is one suggestion regarding the language in Section 404(b). The section states that a State has prudence review authority "unless the wholesale purchaser has no alternative" (emphasis added) to accepting the amount of power allocated to it by the FERC in setting the wholesale rate. Because the United States Supreme Court in Nantahala, supra, used the phrase "no choice," and because the words "alternative" and "choice" have slightly different connotations, it is suggested that the legislative language be the same as that used by the United States Supreme Court.

Conclusion

Both the S. 341 and the NESA PUHCA reforms would be major steps toward revitalizing the electric industry to develop more competitive generation options to meet future needs. To be sure, the Public Utility Holding Company Act of 1935 has served a useful function in breaking up and restructuring an industry that was full of abuses in the 1920s and 1930s, to the detriment of consumers and shareholders. However, in the subsequent 55 years (and in particular the last 10 years) the industry has changed dramatically and the statute as enacted is a severe barrier to developing more efficient, technologically innovative and reliable generating capacity for the next century. Amendment of PUHCA would leave intact FERC and state regulatory protections that did not exist prior to PUHCA, to prevent potential abuses. It would also leave intact a voluntary system of utility generation planning. It would help ensure a reliable, long-term supply of competitively priced power for years to come.

This concludes my statement, Mr. Chairman. I would be happy to answer any questions of the Committee members.

Enclosure A

Specific Questions Raised by the Committee

1) In the last few years the Federal Energy Regulatory Commission has fostered wholesale power competition under the Federal Power Act by permitting sellers that lack significant market power to receive market pricing for the electricity they sell. Such sellers have included conventional utilities as well as independent power producers (IPPs). Please outline the Commission's rulings in this area.

Since 1983 the Commission has addressed requests for non-traditional (i.e., non-cost-based) pricing in 31 cases involving power brokers/marketers, independent power producers, affiliated power producers, and traditional franchised public utilities. A listing of these cases is attached to this Enclosure. The Commission has accepted non-traditional rates in cases where the seller and its affiliates lacked or had mitigated market power over the buyer, and where there was no potential abuse of affiliate relationships which might directly or indirectly influence the market price and no potential abuse of reciprocal dealing between the buyer and seller. In some earlier cases, the Commission also relied on a cost cap based on the buyer's avoided cost or on a variant of the seller's costs.

The Commission's analysis in these cases has evolved as new types of proposals have been filed. However, the Commission generally has analyzed the following factors in reviewing market-based rate requests:

(1) Is the seller or any of its affiliates a dominant firm in the sale of generation services in the relevant market?

(2) Does the seller or any of its affiliates own or control transmission facilities which could be used by the buyer in reaching alternative suppliers?

(3) Is the seller or any of its affiliates able to erect or control any other barriers to entry into wholesale markets?

(4) Is there a potential for self-dealing resulting from affiliations between the seller and a franchised utility, between the seller and a supplier of a key input to electricity production, between the seller and a firm that transports a key input, or between the seller and the purchaser?

(5) Is there a potential for reciprocal dealing on the part of the buyer and seller or their affiliates?

(6) Has the relevant state commission conducted a proceeding or issued an order involving the proposed transaction and, if so, is there evidence in the state record which can be used in assessing the justness and reasonableness of the seller's rates under the Federal Power Act?

As indicated in the attachment, the Commission has allowed market-based rates in all but four of the 31 cases reviewed, although two of the cases involved only experimental rates.

2) In reviewing requests for market pricing, the Commission has generally looked at whether the seller controls transmission to, or has an affiliate relationship with, the buyer of power and, if so, whether this problem can be mitigated. Is prevention of abuse of transmission control and affiliate relationships simply a matter of FERC policy, or is it required in order for market rates to be legally acceptable under the Federal Power Act?

As a general matter, the Commission cases addressing requests for market-based rates indicate that prevention of abuse of transmission control and abuse of any affiliate relationship that could significantly influence the rate -- whether the affiliation is with the purchaser or anyone else -- is required in order for market rates to be legally acceptable under the Federal Power Act (FPA). As discussed below, an examination of market power and potential affiliate abuse is critical in meeting the statutory mandates under the FPA.

The primary reason the FERC was created is to protect consumers against utilities' monopoly power in sales for resale in interstate commerce and transmission in interstate commerce, by regulating the rates utilities charge for wholesale sales. Under Sections 205 and 206 of the FPA, rates, charges, classifications, or any rule, regulation, practice or contract affecting such rate, charge, or classification, must be just, reasonable, and not unduly discriminatory or preferential.

Neither the FPA nor its legislative history defines "just and reasonable." However, the courts have applied two major fundamental precepts in analyzing rates under the statute. First, the courts have deferred to the Commission's reasoned choice of ratemaking methods and held that it is the result reached, *i.e.*, the impact, of the rate order, which is important. See *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944), and *Duquesne Light Co. v. Barasch*, 109 S.Ct. 609, 617 (1989). Second, the courts have held that the ratemaking methodology employed must serve a legitimate statutory objective and produce a rate that falls within a "zone of reasonableness." See *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987).

Traditionally, rates based on a utility's costs plus a reasonable rate of return have been deemed "just and reasonable" under the FPA. Such rates have been found just and reasonable for utilities possessing market power because they protect consumers from exorbitant rates and also assure that rates are not confiscatory to the seller (the "zone of reasonableness" test articulated in *Jersey Central*, *supra*).

With the advent of more competition in the electric industry, entry into the industry of new non-traditional power suppliers lacking market power, and the willingness of traditional utilities to mitigate market power, the FERC has found that market-based rates can also satisfy the "just and reasonable" statutory mandate. To determine whether market-set rates are constrained within a zone of reasonableness, the

Commission has examined the market power of the seller as well as the market power of any of its affiliates, and any affiliate or other abuses that could influence the rate. The rationale behind this type of analysis is that cost-based regulation is not necessary to constrain rates within a zone of reasonableness where the seller and its affiliates have no ability to significantly influence the price paid by the buyer.

Among the sources of market power which can influence a rate is ownership or control of transmission. If a seller or its affiliates own or control transmission, they potentially can preclude a buyer from reaching other sources of supply and instead force the buyer to purchase power from the transmission owner. In other words, they can significantly influence the price consumers have to pay for electricity. To allow such sellers to charge "market-set" rates (and, hence, earn potentially unlimited profits) in these circumstances does not meet the just and reasonable standard of the FPA. The same would hold true where a seller or its affiliates can erect other barriers which would limit the buyer's access to other suppliers such that the buyer is forced to pay high prices.

In addition to determining whether rates are just and reasonable, the Commission is also required under the FPA to determine whether rates are unduly preferential. Affiliate relationships and affiliate dealings not only can convey market power and thereby influence the justness and reasonableness of a rate, but they can also result in undue preference. The FERC therefore has closely reviewed affiliate sales which may be below cost and which may unfairly influence the market rates requested for downstream non-affiliate sales. It has also closely analyzed preferential transmission services offered by one affiliate to another and which may unfairly influence the market rates requested for downstream non-affiliate sales. If one affiliate makes a preferential sale or service available to a second affiliate, and the second affiliate seeks to compete for sales to a non-affiliated third-party, the preferential treatment may unfairly improve the competitive posture of the second affiliate in the marketplace and ultimately harm the non-affiliate, purchaser. Thus, the FERC may reject market rates to non-affiliates on the basis that they are not just and reasonable because of affiliate preferences affecting the rate, and it may reject rates for direct sales or services to affiliates on the basis that they may be unduly preferential.

The Commission has strictly scrutinized transactions involving potential affiliate abuse, and has rejected several market-based rate proposals, three of which involved both direct affiliate transactions and transactions with non-affiliates. (PGE-PGX, TECO Power Services, Terra Comfort and Nevada Sun-Peak, noted in the Attachment).

The Commission recently enunciated a strict test for direct affiliate transactions which may affect pricing to non-affiliates. In TECO, supra, the Commission stated that in cases where affiliates are entering agreements for which approval of market-based pricing is sought, it is essential that ratepayers be protected and that transactions be above suspicion in order to ensure that the market is not distorted. The Commission was particularly concerned about preferential pricing and the ability to divert benefits from the native load ratepayers of a franchised utility to the shareholders of an entity requesting market-based pricing.

In TECO, the Commission stated that concerns about preferential pricing can be eliminated by relying on a market test for an interaffiliate transaction which may affect a downstream non-affiliate transaction. The Commission stated that market value can be established by timely offering to all comers the same services at the same price offered to the affiliate, or by providing the Commission with a benchmark of the market value of similar services based on contemporaneous data. Such services could entail power sales, transmission, fuel sales, or any other service or commodity that could give the seller an undue preference.

In addition to analyzing affiliate abuses such as those described above, the Commission has also analyzed potential collusion, e.g., reciprocal dealing. One potential abuse of reciprocal dealing is through QF contracts. This potential was examined in Commonwealth Atlantic (noted in the Attachment), in which Commonwealth Atlantic, an affiliate of Southern California Edison (SCE), won a bid to supply power to Virginia Electric Power Company (VEPCO), and sought market-based rates for the sale. The Commission carefully examined QF contracts which VEPCO's affiliate, Dominion Energy, had with Commonwealth Atlantic's affiliate, SCE. The Commission assured itself that there had been no "sweetheart" rate paid by SCE for the VEPCO-Dominion QF power which might have influenced SCE's affiliate Commonwealth Atlantic winning the VEPCO bid. This is one example of the types of potential abuses which the Commission examines.

Because the Commission's very premise of finding market-based rates just and reasonable under the FPA is the absence or mitigation of market power, or the existence of a workably competitive market, and because the FPA mandates that the Commission prevent undue preference and undue discrimination, we believe the Commission is legally required to prevent abuse of transmission control and affiliate or any other relationships which may influence the price charged to a ratepayer.

3) Do you believe that Title XV creates any risk of consumer harm through increase in the likelihood of abuse of transmission control and affiliate relationships or otherwise?

Based on the discussion above regarding the legal standards for approving rates, practices, and contracts under the FPA, which would not change if PUHCA were amended, we do not believe that Title XV would create any substantial risk of consumer harm through an increase in the likelihood of abuse of transmission control and affiliate relationships.

The three major concerns of potential consumer harm would come through self-dealing, collusion, and cross-subsidies -- most of which would occur through affiliate abuses. However, both the FERC and states have the ability to monitor and remedy potential abuses. Most EWGs entering competitive markets will be seeking market-based wholesale rates from the FERC. As noted above, the Commission has the ability and statutory responsibility under existing law to protect against affiliate abuses, including self-dealing and collusion, and has rejected several rate proposals where there were potential abuses. In addition, states are already having to deal with self-dealing and cross-subsidy issues in other regulatory areas. Moreover, states can also preclude their local utilities from selling to themselves in order to help avoid potential problems.

An important point which is often overlooked is that under Section 301(b) of the FPA, the Commission shall at all times have access to and the right to examine all accounts, records, and memoranda of licensees and public utilities and to order any other information with respect to those documents. No member, officer, or employee of the Commission may divulge such information except insofar as directed by the Commission or a court. Notably, the Commission has in appropriate circumstances divulged such information at the request of state commissions where necessary to protect the public interest.

Moreover, under Section 301(c) of the FPA, the Commission may order the examination of the books, accounts, memoranda and records of any person who controls, directly or indirectly, a licensee or public utility subject to the jurisdiction of the Commission, and of any other company controlled by such person, insofar as they relate to transactions with or the business of such licensee or public utility.

This pervasive accounting authority applies to accounts, records and memoranda of the generation, transmission, distribution, delivery, or sale of electric energy, the furnishing of services or facilities in connection therewith, and receipts and expenditures with respect to any of these activities. Accordingly, this provides a means by which the Commission and states, through requests to the Commission, can monitor and investigate potential affiliate abuse.

REQUESTS FOR MARKET-BASED PRICING

	Docket No:	Company:	Filing Date:	Order/Letter Issued:
1.	ER84-155-000	Public Service Co. of New Mexico	12/13/83	Competitive market experiment; experimental rates accepted, Opinion No. 203, 25 FERC ¶ 61,469 (1983).
2.	EL86-2-000	Citizens Energy Corp.	10/11/85	Market-based rates accepted, 35 FERC ¶ 61,198 (1986).
3.	ER86-402-000	Catalyst Old River Hydroelectric Limited Partnership	04/11/86	Market-based rates accepted, 36 FERC ¶ 61,200 (1986).
4.	EL86-33-000	EUA Power Corp.	04/17/86	Market-based rates accepted as part of settlement 36 FERC ¶ 61,017 (1986).
5.	ER86-444-001	Citizens Energy/Los Angeles, California	04/28/86	Market-based rates accepted, 36 FERC ¶ 61,332 (1986).
6.	ER87-97-001, -002, & -003	Pacific Gas & Electric Co.	02/04/87	Western Systems Power Pool Experimental market-based rates accepted, 38 FERC ¶ 61,242 (1987); experiment extended, 47 FERC ¶ 61,121 (1989); 50 FERC ¶ 61,339 (1990).
7.	ER87-299-000	Citizens Energy/City of Pasadena	03/13/87	Market-based rates accepted, Letter, 4/17/87.
8.	ER87-496-000	Baltimore Gas & Electric Co./PJM	06/18/87	Market-based rates accepted, 40 FERC ¶ 61,170 (1987).

REQUESTS FOR MARKET-BASED PRICING - continued

	Docket No:	Company:	Filing Date:	Order/Letter Issued:
9.	EL87-50-000	Howell Gas Mgmt.	07/02/87	**Market-based rates accepted, 40 FERC ¶ 61,336 (1987).**
10.	ER88-112-000	Orange & Rockland Utilities, Inc.	11/20/87	**Market-based rates accepted, 42 FERC ¶ 61,012 (1988).**
11.	ER89-133-000	Pennsylvania Power & Light	12/20/88	**Market-based rates accepted, Letter, 2/17/89.**
12.	ER88-219-000	Pacific Gas & Electric Co./Turlock	01/29/88	**Market-based rates accepted, 42 FERC ¶ 61,406, 43 FERC ¶ 61,403 (1988).**
13.	ER88-302-001	Pacific Gas & Electric Co./Modesto	03/30/88	**Market-based rates accepted, 44 FERC ¶ 61,010 (1988).**
14.	ER88-440-000	Potomac Electric Power Co.	05/31/88	**Market-based rates accepted, Letter, 7/27/88.**
15.	ER88-478-000	Ocean State Power	06/21/88	**Market-based rates accepted, 44 FERC ¶ 61,261 (1988).**
16.	ER89-179-000	Citizens Energy/Pasadena	01/19/89	**Market-based rates accepted, Letter, 5/26/89**
17.	ER89-401-000	Citizens Power & Light Co.	05/02/89	**Market-based rates accepted, 48 FERC ¶ 61,210 (1989).**
18.	EL89-32-000	Torco Energy Marketing Inc.	05/30/89	**Market-based rates accepted, 48 FERC ¶ 61,294 (1989).**

REQUESTS FOR MARKET-BASED PRICING - continued

	Docket No.:	Company:	Filing Date:	Order/Letter Issued:
19.	ER89-580-000 & ER89-581-000	PGE/PGX (Portland)	08/01/89	Market-based rates denied in part, 51 FERC ¶ 61,108, 51 FERC ¶ 61,379 (1990).
20.	ER89-672-000	Public Service Co. of Indiana (PSI Energy, Inc.)	09/25/89	Market-based rates accepted, Opinion No. 349, 51 FERC ¶ 61,367, 52 FERC ¶ 61,260, 53 FERC ¶ 61,131 (1990).
21.	ER90-12-000	United Illuminating	10/04/89	Market-based rates accepted, Letter, 11/13/89, 50 FERC ¶ 61,017 (1990).
22.	ER90-24-000	Commonwealth Atlantic	10/17/89	Market-based rates accepted, 51 FERC ¶ 61,368 (1990).
23.	ER90-40-000 ER90-41-000 ER90-488-000 & ER90-489-000	Iowa Southern Utilities Terra Comfort	10/30/89	Market-based rates denied, 52 FERC ¶ 61,241 (1990).
24.	ER90-80-000	Doswell	11/22/89	Market-based rates accepted, 50 FERC ¶ 61,251 (1990).
25.	ER90-164-000	TECO Power Services/Tampa Electric Co.	01/18/90	Market-based rates denied, 52 FERC ¶ 61,191, 53 FERC ¶ 61,202 (1990).
26.	ER90-168-000	National Electric Assoc. Ltd. Partnership	01/19/90	Market-based rates accepted, 50 FERC ¶ 61,378 (1990).

REQUESTS FOR MARKET-BASED PRICING - continued

	Docket No.:	Company:	Filing Date:	Order/Letter Issued:
27.	ER90-225-000 & EL90-17-000	Chicago Energy Exchange of Chicago	02/21/90	**Market-based rates accepted,** 51 FERC ¶ 61,054 (1990).
28.	ER90-278-000	Dartmouth Power	03/21/90	**Market-based rates accepted,** 53 FERC ¶ 61,117 (1990).
29.	ER90-290-000	Enron Power	03/28/90	**Market-based rates accepted,** 52 FERC ¶ 61,193 (1990).
30.	ER90-567-000	Pacific Gas & Electric Co./SMUD	08/31/90	**Market-based rates accepted,** 53 FERC ¶ 61,145 (1990).
31.	ER91-11-000	Nevada Sun-Peak Ltd.	10/02/90	**Market-based rates denied,** 54 FERC ¶ 61,264 (1991).

The CHAIRMAN. Thank you, Ms. Marlette. Both you and Ms. Stuntz have stated that the problem of cross-subsidy and self-dealing is not really a problem under this legislation.

Do I understand that to be your testimony?

Ms. MARLETTE. I think it is a legitimate concern, but I think that we have the authority, and indeed as I stated, the mandate to take care of those problems.

And from the FERC's perspective, we have on a case-by-case basis, I think very thoroughly scrutinized for any potential abuses——

The CHAIRMAN. You are already doing that and you would also—the problem is not fundamentally different under this legislation than what you deal with right now?

Ms. MARLETTE. That is correct.

The CHAIRMAN. And you are adequately taking care of that right now.

Ms. MARLETTE. We believe so.

The CHAIRMAN. And you agree with that, Ms. Stuntz, although you would like to sort of assure everybody with a statutory restatement of, which I believe would be a redundancy, but you think that that can be adequately dealt with, so while it is a legitimate concern, it is a legitimate consideration, it is not a concern. Is that correct?

Ms. STUNTZ. I think it is a legitimate concern. I think that from FERC's perspective, they are doing everything that they can and should to make sure that that concern is not realized.

We do think, however, that clarification of this authority, as I said, is necessary, in part to put us on sort of a proactive basis rather than a reactive basis, not to leave these matters to be discovered and dealt with after they have happened, but to affirm the authorities and to make it known up front that FERC will exercise those authorities, and to give the States the ability—who are, after all the most concerned, I think, about cross-subsidies; who have concerns about whether FERC is looking at the right things—to give them——

The CHAIRMAN. If we did write it in, you would have—that would then allay any concern you would have?

Ms. STUNTZ. Yes, it would.

The CHAIRMAN. In other words, it is a problem that can adequately be dealt with, regulators who are charged with that mandate?

Ms. STUNTZ. That is correct. If it is clear, if it is clarified that State regulators do have a role in this, as do FERC, and what their respective roles are.

The CHAIRMAN. Mr. Fleischman, I understand your testimony to be, really the substance of it is that the factors, the circumstances that led to PUHCA's original enactment no longer are existent because of SEC's present requirement for disclosure and the competitiveness of the market based on that disclosure.

Do I understand that correctly?

Mr. FLEISCHMAN. Yes, Mr. Chairman. That, plus 55 years of doing the job that Congress gave us to do.

The CHAIRMAN. All right. You note in your testimony that SEC may adopt a more flexible standard concerning consolidated debt ratios, particularly involving investment by registered holding companies and EWG's.

What might an appropriate standard be?

Mr. FLEISCHMAN. The SEC has not addressed that question, Mr. Chairman. We do see EWG's as nontraditional power generators, with a type of financing that frequently, as we understand it, will be dependent on nonrecourse debt, which will give us the opportunity to exercise a degree of discretion in fashioning a prudent standard in the newer circumstances.

The CHAIRMAN. Is there any reason why the SEC would restrict financing authority for registered holding companies to a specific project as opposed to a generic project, a general EWG investment company, let us say?

Mr. FLEISCHMAN. I take your question, Mr. Chairman, to relate to registered holding companies that wish to invest in EWG's?

The CHAIRMAN. That is correct.

Mr. FLEISCHMAN. The way the bill, S. 341, is drafted our concern remains the concern at the stage when the registered holding company seeks to do its financing either to use those funds for EWG investment or to replenish the funds that have already been used for EWG investment.

We would have to look at the holding company itself, and fulfill the responsibilities that we have always had since they are not changed by this legislation, to assure that the consumer investor and public interest protection standards of the 1935 act are maintained in the financing ratios of the public utility holding company.

Those have, as you have suggested, in the past recently been held at a 65 percent debt, 30 percent equity and perhaps 5 percent preferred stock level, but we are aware that investments in EWG's are somewhat different and may elicit from the SEC a different kind of response to registered companies that seek to invest in EWG's.

The CHAIRMAN. Thank you.

Ms. Stuntz, it is argued that because EWG's and holding companies, registered or nonregistered, presently use the same architect-engineers are likely to use the same architect-engineers and the same technology, that therefore there should be no savings by consumers.

What is your response to that argument?

Ms. STUNTZ. Well, I can only refer to the data that we have to date, which is that there have been many instances that utilities have found independent power producers and QF's able to offer and provide facilities for significantly less than they themselves could build it.

Part of it is the regulatory structure in which utilities would have to function in building it themselves. Part of it is the technology risk-benefit-reward situation that I discussed in my opening statement.

But we addressed that in the back-up study in terms of a cost-benefit analysis. It is, as we pointed out, it is not possible to do a definitive cost-benefit analysis of something like PUHCA because you cannot predict with certainty how the industry will respond.

But based on the data available to us, there are substantial savings to be achieved, even below QF's, which by definition are supposed to be cheaper than the utility could itself build for or they would not be coming in the first place.

So again, because we are not mandating it, we think it is a matter of providing an opportunity for a lower cost supplier to come in, and we do not understand why that should create problems for anyone.

The CHAIRMAN. Now when I made my opening statement, I talked about the advantages of being able to allocate risk under this legislation, as opposed to the present legislation.

Do you agree with that, and if so, tell me why.

Ms. STUNTZ. I do agree with that. I think what you can see in these competitive procurement situations is a situation where the company knows up front, if I win the bid, this is what I have to produce the power for. Anything that I can do to produce it more cheaply than that will insure to my benefit.

If I have problems with the construction of the plant, I am going to absorb that risk, not the ratepayers. So this puts incentives on that builder to arrange with natural gas supply contractors, for example. They can enter into fixed long-term contracts, which many of the IPP's and QF's have been doing, to shift some of that burden on the natural gas supplier, for example, or the coal supplier in many cases.

A purchasing utility can accept as much or as little risk as it and its public utility commission decide is appropriate in terms of what priority to accord to cost as opposed to reliability, as opposed to fuel diversity.

All of those things enter into a utility's and a PUC's decision as to what mix of generating capacity should be brought on.

The CHAIRMAN. Now, in my opening statement I may have been unduly harsh on utilities, and say that some of the resistance may be because now they can build a big plant. They can put it in the rate base and are guaranteed a profit.

As a practical matter, why would they want to buy electricity for a cheaper price if it is just a pass-through, when now they can get this big investment, put it in the rate base and get a guaranteed profit?

Ms. STUNTZ. Well, I guess I do have to say, I think there have been instances, many, particularly over the recent past, where utilities have been second guessed by regulatory commissions, and they have not—and many times it is through no fault of their own, and many times through perhaps some lack of management expertise—not been allowed to put things in the rate base. So I do not think it is a totally risk free situation for them even under the traditional regulatory structure.

The CHAIRMAN. Well, that is really only in nuclear, is it not?

Ms. STUNTZ. Well, it has happened in coal plants as well, that I am aware of. But I think that, I have asked——

The CHAIRMAN. But that prudence review is usually on a question of how they construct it. I mean, if they get the right technology and there is usually a menu of prudent investments, fashions change with PUC's from time to time, but if you sort of get from the right menu and hire the right architects-engineers, I do not mean to say that they are favoring any, but get a good solid one.

And they build it, using ordinary building practices, then they are going to be able to rate base that, are they not?

Ms. **Stuntz**. That is generally the case. Sometimes if they overshoot demand and they end up with capacity coming on that the demand has not materialized for—as, again, we saw in the early 1980's, not so much more recently—that can cause them a problem.

But it is one of those things, the very sort of syndrome you mentioned, that tends, I think very understandably, to cause regulated utilities to be somewhat risk-averse, to use the known technologies, the known builders, so that they cannot be, or at least are less likely to be, second-guessed.

The **Chairman**. And really what this thing is about, what this bill is about, I said, and would you not agree, is about competition. And we have found in PURPA that competition works. That it gets you a better price and a reliable source of energy and the consumer is better off and therefore the country is better off.

I mean, is that not perfectly clear from PURPA? Is it not?

Ms. **Stuntz**. I believe it is. I just would say, in fairness, that we have to keep in mind that this is a very pervasively regulated industry with complicated relationships between State and Federal authorities.

And what we are trying to do is to allow the opportunity for more competition to occur. But it is not an industry that, at any time I think, we could envision being totally deregulated.

So we need to make sure, and I think you have taken your time, we have taken our time, to try to make sure that what we are proposing is consistent with the existing regulatory structure that has to remain in place to protect consumers.

The **Chairman**. Absolutely. I do not propose a total deregulation. But we would like to have a choice there, between those who can share the risk, can have all kinds of innovative management techniques. I mean, that is what free enterprise is all about, it seems to me.

Well, I have a number of other questions, which I will ask in writing, but let me at this point call on Senator Nickles.

Senator **Nickles**. Mr. Chairman, thank you very much, and thanks to all of our panelists.

Mr. Fleischman, you mentioned, you were talking about the—you mentioned the equity requirements that are under PUHCA today.

What are the capital requirements, if there is to be a project? Is that by statute or by regulation?

Mr. **Fleischman**. If there is to be a project, Senator Nickles?

Senator **Nickles**. Yes. If you have a capital project, did you say that 65 percent debt, and 35 percent equity?

Mr. **Fleischman**. Away from the EWG world, Senator Nickles, in the normal course of regulating the registered public utility holding companies, the SEC has generally limited the capital structure of registered companies to about 65 percent debt and 30 percent equity.

Senator **Nickles**. For the total company or for an additional project?

Mr. **Fleischman**. That is for the registered holding company, on a corporate and consolidated basis.

Senator NICKLES. I see. So the holding company debt could not exceed, say 65 percent? So if you had a holding company that wished to have a $200 million expansion, they would have to make sure that their debt/equity ratio did not exceed the 65 percent?

Mr. FLEISCHMAN. In the normal course, away from the EWG world, yes.

Senator NICKLES. Okay. Now, you qualified that, away from the EWG. Does that mean under EWG, that a utility would have greater equity or greater debt ratio?

Mr. FLEISCHMAN. The EWG would be financed separately, and the question that would come to us, Senator Nickles, is what happens when the registered holding company seeks to obtain the money from outside to do that financing.

To the extent that the EWG finances itself on a nonrecourse basis, away from the parent, the parent would not be required to put in its own money. It might be required to guarantee, but not to put in its own money.

The SEC has historically not had to face that kind of problem. In the EWG world, looking forward, it is reasonable to anticipate that the Commission will exercise a degree of flexibility in adapting its prior standards to those circumstances in which the registered company is investing solely in the equity of the EWG, and is allowing the EWG to finance itself on a nonrecourse basis, away from the registered company.

Senator NICKLES. Well, I would encourage that flexibility. Because one of the complaints or inequities that I have heard made by some of the utilities is that the separate IPP or EWG would be able to come in, use a more heavily leveraged situation, giving them an undue advantage versus the utility.

And I think we want to have, or at least I want to have, and I think most all of us do, would like to see somewhat of a level playing field as far as these alternatives are concerned.

I did not want that prohibited by statute. I am hearing you say that you have some flexibility, so it must be——

Mr. FLEISCHMAN. It is by guideline of the SEC.

Senator NICKLES. Okay. Thank you very much.

Ms. Stuntz, I heard the administration basically state that you were supportive of significant changes. I also heard, and I think you mentioned that there were some differences.

I heard your accolades for the similarities between the administration proposal and the Johnston-Wallop proposal. What are the main differences between your proposal, dealing with PUHCA and the committee bill?

Ms. STUNTZ. Senator, I would say there are three. Two deal with consumer protection concerns that we believe have been raised and are legitimate and require some explicit attention in PUHCA reform legislation.

One of those is the issue of self-dealing or dealing with affiliate transactions. In order to deal with that, we clarify, as I believe we discussed earlier with Ms. Marlette, that the FERC does indeed have the authority to declare as not just and reasonable, a rate that it finds an EWG gets an undue advantage from selling itself.

On the other hand, we also—that sort of takes care of the sales rate—we also clarify—for purposes of the purchases, which are generally regulated by the States—that the State has the ability to say, even if FERC has found that not to be an unjust and unreasonable rate we at the States believe that it does not lead to a prudent transaction because of self-dealing or affiliate transactions involved, which is the so-called Pike County doctrine.

We believe it is important to clarify and codify that as well. That is one of the things NARUC asked for in its resolution on the Johnston bill and we believe that is appropriate.

Finally, we also, in the nature of consumer protection, give the States an ability to deal with the cross-subsidy issue. The States expressed concern about that. We looked at it and made the determination that if the States feel the books and records are not being kept in a way that allows them to say, we feel comfortable, we can police any potential cross-subsidization, that there is a problem, and there should not be an exemption from the Public Utility Holding Company Act.

So States have an ability to ensure when dealing with a company under the Public Utility Holding Company Act or that would otherwise be there, that yes, the books and records are being maintained in a way that we can police cross-subsidization.

The other primary difference is the provision in the Johnston-Wallop bill which would allow a utility to declare, for 10 years, that it will not purchase or participate in an EWG or EWG transactions.

We believe that is not consistent with the overall thrust of the bill to promote competition, and are very concerned about that, and the matter of State/Federal relationships as well, to provide as a matter of Federal law, basically, an ability for a utility to say, we are going to opt out of this business even if the States would like us to participate in competitive procurement or other kinds of competitive generation alternatives.

Senator NICKLES. But did I not hear you state that the proposal that you had would not force the utilities to take the power? I thought I made note of that.

Ms. STUNTZ. That is right. We are not forcing people. But neither do we want to give a utility a right they do not now have, which is to say, as a matter of Federal law, we are not going to do this for 10 years, and neither States nor anybody else, regardless of what they might think, should regulate us to do this.

Senator NICKLES. So you are saying the legislation would not force it, but you would still leave the State commissions the authority to deal with the matter?

Ms. STUNTZ. Which they have now——

Senator NICKLES. So the State commissions may well force it. Right now, I guess, I know there has been a lot of contention within some of the utilities and some of the, I guess I will say IPP's or under PURPA, cogens, over the issue of capacity.

I know we have a big debate in my State on capacity, cogens are saying we need additional capacity. Some of the utilities are saying, no, there is additional capacity, we are in good shape.

Does this change that criteria? Is the decision made, still can be made by the local State commissions, even though you are dealing with interstate commerce? Would FERC be involved in that capacity decision?

Ms. Stuntz. No, Senator. This would not affect that determination at all, which would be left really with States to determine under PURPA, what is the avoided cost that the utility would have. And generally speaking, if the utility does not need additional power, that avoided cost is going to be very low, such that you are not going to have a lot of cogeneration or QF power coming in. But that is left, that is not touched by this legislation.

Senator Nickles. Nationally, are we in good shape as far as electric capacity or are we looking at shortages in a few years if we do not have additional plants brought on?

Ms. Stuntz. Nationally, that is a hard question to answer. I think you have to look regionally, and there the ranges are pretty broad.

Kevin Kelly, who is with me, the Director of the Office of Electricity Policy, has spent a great deal of time recently with the North American Electrical Reliability Council and NARUC.

It does appear that certain parts of the country, the Northeast, the Northwest, are not necessarily going to be short, but right on the edge, and are definitely looking at having to procure additional supplies.

The Midwest, on the other hand, appears to still be in a surplus position, at least for the near future. Florida appears to be in a situation where they will need to procure additional supplies or build additional supplies fairly soon.

So it is a regional question. A lot of depends upon how some of the demand programs that are being put in place, how they materialize, how much is really saved. Obviously, a lot of it depends on the economy.

We do not foresee any crisis situations right now. But we think that it will help everyone to provide the greatest number of options for new capacity procurement that are available.

Senator Nickles. Thank you very much.

Mr. Chairman, I have some additional questions I would like to submit to the panel in writing.

The Chairman. Thank you very much, Senator Nickles.

I believe Senator Shelby is next.

Senator Shelby. Thank you, Mr. Chairman.

I would like to revisit some of the subject matters that Mr. Fleischman was asked. Mr. Fleischman, as a commissioner, you are in your second term and you bring some unique qualifications, having spent 26 years as a securities lawyer before you went to the SEC, I believe.

Under the proposed legislation, as I understand it, exempting holding companies, nonholding company utilities and IPP's can secure financing for their projects without seeking SEC approval.

At the time, registered holding companies are required to have SEC approval for their financial of EWG's. Do you feel, Commissioner Fleischman, that this puts registered companies at a disadvantage?

In other words, we were talking about competition, but fair competition, I believe, as Ms. Stuntz mentioned. Do you want to comment on that?

Mr. Fleischman. Senator Shelby, you gave me a compliment before you asked your question. The SEC not only has a very strong staff, but has always, as you well know, been blessed with very strong commissioners.

I have a colleague, Commissioner Roberts, who came from your staff. I do not consider myself unique, just gifted with a number of very strong colleagues, as has been the SEC's tradition.

Senator **Shelby**. When you bring 26 years of security and corporate practice to the SEC and you are in your second term, I think that deserves mentioning.

Mr. **Fleischman**. Thank you, sir.

I hope second terms are not unique at the SEC.

Senator **Shelby**. Second, third——

Mr. **Fleischman**. Registered companies are, I suppose, at somewhat of a disadvantage, Senator. It need not to be so. There are economic circumstances in which the funds desired by the registered holding companies to be invested in an EWG will be available.

And therefore, since the structure of these two bills is that the SEC would retain its jurisdiction over the sale of securities by the registered holding companies, if that step were not necessary, either to provide the funds or to replenish the funds, why the registered company could move under this legislation just as quickly as anyone else.

Senator **Shelby**. Is this by law rather than regulation, if this is a requirement now?

Mr. **Fleischman**. Law.

Senator **Shelby**. That is what I thought.

Mr. **Fleischman**. But as a practical matter, there will be circumstances in which the registered companies will have to go through the declaration/application process that is prescribed under the 1935 act.

Senator **Shelby**. Is this called a filing?

Mr. **Fleischman**. That will do as well as any other word, Senator.

Senator **Shelby**. Okay. And how long do these filings take to process?

Mr. **Fleischman**. They can, without opposition, move through the Securities and Exchange Commission and its staff in a period of anywhere from 40 to 60 days.

Senator **Shelby**. That is without opposition.

Mr. **Fleischman**. Without opposition.

Senator **Shelby**. Now what if there is intervention?

Mr. **Fleischman**. If there is intervention and the commission does not find that the intervention essentially is frivolous, then the process can be drawn out over a very long period of time.

Senator **Shelby**. What is your criteria to decide at the commission whether an intervention is frivolous? Do you have some guidelines or would you rather keep those——

Mr. **Fleischman**. I used that word "frivolous." The applicable standard is a substantive question of law or fact.

Senator **Shelby**. But some interventions could take quite awhile, could they not?

Mr. **Fleischman**. Years, Senator Shelby.

Senator **Shelby**. And what would that do to a utility subject to the holding company act? You would just put them out of business.

They are not going to be building anything if there is a protracted intervention.

Mr. FLEISCHMAN. That could happen. No matter how long other sources of financing took, that could put the registered holding behind the eight ball for this purpose, yes.

Senator SHELBY. Comment again, if you will, Commissioner Fleischman, how the competitive disadvantage by the utilities now, if this law were to take effect, how it could be overcome, just succinctly.

Mr. FLEISCHMAN. Although it is not provided in this legislation, Senator Shelby, the Congress could revisit the provisions of the 1935 act that have to do with process, and go to what sometimes has been called a more traditional licensing procedure for the SEC to administer, where, if we were going to approve, we might be able to do it in a more expedited way.

Only if we were going to deny the application would we have to take a long time.

Senator SHELBY. What would that take? More legislation to that?

Mr. FLEISCHMAN. It would take addition to the bills that are pending before you.

Senator SHELBY. Such as, could you elaborate? In other words, what would have to be done to streamline that?

Mr. FLEISCHMAN. The declaration and application procedures in sections 6 and 7 of the 1935 act would have to be addressed by this committee and the Congress.

Senator SHELBY. At the present time, we all know that there is a lot of infrastructure——

The CHAIRMAN. Excuse me, let me ask if the Senator would not mind yielding. Are you suggesting that should be done?

Mr. FLEISCHMAN. The SEC would be pleased to work with the committee to achieve language to do that if the committee decides that there is in fact the kind of disadvantage to the registered companies that the committee wants to attack.

The CHAIRMAN. Do you believe there is? Should we address it?

Mr. FLEISCHMAN. We would find our procedures benefited if the committee chose to address that subject. We would be happy to cooperate.

The CHAIRMAN. Would you give us some language on that, some suggested language?

Mr. FLEISCHMAN. It would be our privilege, Mr. Chairman.

The CHAIRMAN. Senator Shelby?

Senator SHELBY. Thank you, Mr. Chairman.

Commissioner Fleischman, under the present law, the Public Utility Holding Company Act, it is my understanding that law would prevent a lot of our utilities, particularly those under the SEC, your jurisdiction, from participating in things like the rebuilding of a power plant or other things that they have expertise in, in something like Kuwait.

Is that true or not true?

Mr. FLEISCHMAN. The interplay between the operation of the 1935 act domestically and——

Senator SHELBY. Okay, and foreign?

Mr. FLEISCHMAN. And foreign, is a technical subject that was addressed, as a matter of fact, by one of the people sitting in your audience, before the hearing began with a question to Ms. Smythe and Mr. Weeden.

And with your permission, Senator, I would like to ask Mr. Weeden to answer that question.

Senator **Shelby**. Go ahead.

Mr. **Weeden**. Well, the situation with a registered holding company, for example, if they wanted to assist Kuwait, we have situations, there are a number of registered holding companies that have consulting subsidiaries that will go to a country and suggest and consult on how to do this and that with respect to building the infrastructure.

But they cannot, as a registered holding company, own and operate, own or operate those electric facilities. They can only consult, and that is as far as we can——

Senator **Shelby**. Notwithstanding their expertise in the area, notwithstanding it would be a solid investment, they are just prohibited outright from doing that, owning it?

Mr. **Weeden**. The staff's interpretation for a registered holding company, that is correct.

Senator **Shelby**. Mr. Chairman, thank you for your indulgence. My time has expired.

The **Chairman**. Thank you very much.

Senator Craig, I believe was here next.

Senator **Craig**. Let me say, Mr. Chairman, thank you very much, and to all of you, thank you.

I am reading as fast as I can to develop a working knowledge so that I can ask responsible questions. I am not quite there. So I would certainly reserve the right to respond in writing and to ask questions of them, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Craig.

Senator Conrad, I believe was next.

Senator **Conrad**. Thank you, Mr. Chairman.

Mr. Fleischman, was it important to pass PUHCA in 1935?

Mr. **Fleischman**. Yes, sir.

Senator **Conrad**. Why?

Mr. **Fleischman**. Your predecessors here in the Senate took care to tell my predecessors at the Securities and Exchange Commission why, Senator Conrad.

There is a long prelude to the Public Utility Holding Company Act that expresses the purposes of the act in terms of the abuses that the Senate and the House and the President in 1934 and 1935, on the basis of 7-year studies prior to that time, found prevalent in the industry.

Senator **Conrad**. So there were serious abuses that were occurring. Self-dealing, is it fair to say, was one of those abuses?

Mr. **Fleischman**. Cross-subsidization was a problem even back then, yes, sir.

Senator **Conrad**. Do we not open ourselves up to a repeat of those abuses if we make the changes in PUHCA that are advocated here today?

Mr. **Fleischman**. Senator Conrad, I do not think that the SEC has any monopoly on the ability to deal with that type of abuse. We have already heard from your other witnesses here today that FERC feels it has the power to address the cross-subsidization issue, and that it would have the power, even if the Senate did not clarify the law.

Senator CONRAD. So let me see if I can get at this in a little different way. In your judgment, from what I am hearing you say, is that the facts have changed in terms of ways of preventing those abuses since PUHCA was passed in 1935? Would that be your testimony?

Mr. FLEISCHMAN. Yes, Senator. Our sister agency, born under this very statute in 1935, although in a different name, is capable of dealing with the facts, as changed.

Senator CONRAD. Could I ask the department if you could focus on the regulatory protections relative to affiliated transactions and nonutility ownership of generating facilities?

Let me preface that by asking you, should we be concerned about nonutility ownership of generating facilities? As you know, that was one of the concerns that was addressed in the original legislation.

Is that something we should still be concerned about?

Ms. STUNTZ. I do not believe so, not just that. If what we are talking about is an unaffiliated, electric wholesale generator, which would remain subject to FERC regulation as a wholesale seller of electricity, existing regulation of that unaffiliated EWG under traditional FERC practice, would be adequate to resolve any concerns with respect to the reliability or price of that power.

Senator CONRAD. And specifically, with respect to affiliated transactions, I come from a background of audit, and in my experience, these are not easy questions.

It can be very, very difficult to unravel what is precisely going on. Could you just review with us your assessment of the problem of ascertaining whether there is abuse with respect to affiliated transactions?

Ms. STUNTZ. I do not have an audit background, Senator, but I have practiced law, and I am aware that these issues are complicated, and are in fact confronted now on a daily basis by State public utility commissions and by FERC as they look at transactions because there are very few power providers that have no other affiliates whatsoever that do anything else, or are not telephone companies or other kinds of utilities.

So there are no wholly novel issues that would be generated by this act that are materially different from the types of issues that occur now.

But we recognize that they are difficult. We think that they do require some explicit treatment in the PUHCA reform legislation and we have done that really in three different ways.

And this gets very complicated, but depending upon the relationships between the wholesale generator and an affiliate, and whether that affiliate is a simple utility, whether it is a company now exempt under the holding company act because of the statutory exemptions, or whether it is in fact a registered company, we have slightly different consumer protections that would pertain in each of those circumstances that I think are appropriate, given the nature of the risk if you will, that would be involved. I can go through these in detail now or provide it for the record, whichever you would prefer.

Senator CONRAD. If you could provide those for the record. Let me just ask you, are you confident then that if this legislation were to pass, that we would not revisit the dark days of the 1930's, when the abuses grew up which led to the passage of PUHCA?

Ms. STUNTZ. Yes, sir, I am.

Senator CONRAD. I do not know how much time I have here, Mr. Chairman.

The CHAIRMAN. We were trying to work on sort of a 5-minute rule with a little flexibility.

Senator CONRAD. If you could advise me, have I exceed the 5 minutes?

The CHAIRMAN. I think you are probably over, but go ahead and ask another question or two.

Senator CONRAD. The other question I would have of these witnesses is a question of need. For those of you who have looked at this situation with respect to the need for change, in looking at the FERC Transmission Access Report and the GAO study on competitive power purchases, it shows that there is an over-subscription of bids now by a factor of 7 to 10 times.

So does that not tell us that under the existing regulatory scheme, these markets are developing without need for change?

Ms. STUNTZ. I will go first on that, if I may, because I think it is a good question. And the point is, as I tried to enunciate in my opening statement, it is not that we are introducing competition.

Competition clearly exists. What I think we are doing is allowing the best bidders, the best potential participants to enter into that competition.

Right now, it is true that many of the solicitations have been over-subscribed, but in fact, what has occurred and it is outlined in the report that we provided to the committee today, in a couple of instances, some who would have—IPP's who would have provided lower priced power were unable to get Public Utility Holding Company Act exemptions, had to be replaced by QF power which was more expensive.

We do not see any reason for that to occur, to artificially or unnecessarily, in our view, constrain the universe of bidders who can enter into that competition.

Ms. MARLETTE. I think I would agree with what Linda said. The competitive procurements clearly show that there are many, many willing suppliers out there.

I think one of the problems we are seeing is that you are excluding other potentially even lower-cost reliable suppliers, and in addition, many of those who are bidding are being restrained by PUHCA. Before power goes on line they are going to have to undertake restructuring, reconfiguring their ownership structures, in order not to be subject to PUHCA restrictions, and I think there is a cost to society of that. If you saw some of the ownership structures that we have seen at the FERC, which may go through several changes, I do not think that that benefits us, either.

The CHAIRMAN. If the Senator would yield at that point, is it not also true that in many areas you do not have steam sources? We are running out of steam sources under PURPA, so that in those areas where you have competition and there are plenty of steam sources, you have got plenty of competition. Where you do not, you do not have the competition.

It is regional, it is anecdotal, and some places have competition and some do not, and most of those steam sources have already been used to generate that 30,000 megawatts that we have got now. Am I correct on that?

Ms. **Stuntz**. I believe you are, and I would say, and Ms. Marlette can confirm, what we are also seeing now is greater and greater imagination applied to come up with steam sources or facilities that qualify as QF's, whether they are catfish farms or greenhouses, something to get by that 5 percent thermal requirement, and again I would agree with her completely that it is not necessarily a productive or constructive use of our capital.

Senator **Conrad**. I thank the witnesses. I thank the Chairman.

The **Chairman**. Thank you.

Senator Seymour.

Senator **Seymour**. Thank you, Mr. Chairman.

The concept and notion theory, if you will, of PUHCA reform is one that generally I certainly concur with. On the other hand, on the basis that it increases competition and creates greater supply and moves supply where it is needed.

On the other hand, having spent 8 years in elected office in a city that had its own small but very viable and effective municipal utility company, my concerns from that standpoint deal with the transmission lines, Ms. Marlette, and the ability to have access, fair access to those lines—nondiscriminatory access—as well as being able to gain access at a reasonable and a fair price, whatever that means.

My question to you would be, what assurances can you provide that the Federal Energy Regulatory Commission would assure nondiscriminatory access at a fair and reasonable price?

Ms. **Marlette**. I think, as Chairman Johnston pointed out at the beginning of the session today, Congress clearly has set up a statutory scheme which does not allow common carriage, which of course would provide everyone nondiscriminatory access.

However, Congress has given the Commission a few limited sections by which it can order access. Those are very limited indeed, but I think the point I would make importantly is that the competition that we have already seen in the past few years is putting increasing pressure on the transmission system and utilities are beginning to voluntarily open up their transmission systems. Public Service of Indiana is one, several Wisconsin Utilities, Pacific Gas & Electric.

Many of these utilities also want to compete. They see competitive markets coming, and they know that if they will mitigate their market power over transmission, let others use their transmission, then they can in exchange sell generation at market-based rates. That is one avenue.

But I think another avenue—and the NES has recommended that the Commission explore more thoroughly its flexibility and authority under the statute—is that the Commission has to ensure that rates, services, and contracts affecting rates and services, are nondiscriminatory and nonpreferential.

I think that under the statute a utility cannot deny a similarly situated customer requesting transmission, deny service or charge it at a discriminatory rate, and I think that entities that do seek transmission can come into the Commission and file a complaint that they are being discriminated against.

There is not clear legal authority as to how far the Commission can go, but I believe that the Commission does have the authority to remedy undue discrimination and anti-competitive effects on a case-specific basis where transmission is being denied or is being given at an unduly discriminatory rate.

Senator SEYMOUR. Well, as I get older I realize my memory loses its capacity, but if my memory serves me correct, in those 8 years that I served in elected office at the local level I can remember we filed a complaint, and it was millions and millions and millions of dollars and years later before we ever got the complaint resolved.

Therefore, I am interested—personally, I want to support reform, but I am really concerned that what I have heard from you does not give the types of assurances that I for one would feel more comfortable that nondiscriminatory access at a reasonable and fair price will be achieved through PUHCA reform and therefore let me ask the question once more, and then I will finish, Mr. Chairman.

Let me ask one more time, more specifically, what would be your recommendations on PUHCA reform to answer that concern?

Ms. MARLETTE. I think that the PUHCA reform bills will add the options. I think it is up to the Commission because of the changing conditions in the market, the competitive and continuing competitive pressures, putting pressure in turn on transmission, will move the Commission to take a more expansive view and to encourage transmission access wherever it can.

There are a number of avenues where the Commission cannot mandate but can indeed encourage, and I think we have already begun to take steps doing that, and as I said, many utilities have. We cannot simply mandate, but I would mention that there are two sections in the statute, one of which is section 207, which are untested.

We have a complaint now pending where a State commission has come in and asked the Commission to look at whether adequate proper service is being provided. That is one avenue, and I think that with the NES recommendation that the Commission looked at, that the Commission will seriously look at what it can do.

I think in sum I would say that we are far from, in my opinion, needing some sort of mandatory transmission authority. I think the pressures are there, and we are going to evolve toward a more voluntary regime in any event.

Senator SEYMOUR. I would agree with you, and I do not think your authority should be mandated. On the other hand, the length of time and the bureaucracy of processing through the complaint system does not leave one who represents the interests of a small public utility, for example, with a very high comfort zone, but in any event I thank you, and thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Seymour.

Senator Wirth.

Senator **Wirth**. Thank you, Mr. Chairman. My apologies for not being here at the start of the hearing.

I have just been this morning finishing a piece of legislation that I have been working on with the public service company, the Independent Petroleum Association of the Mountain States and Coastal, a remarkable coalition of producers and distribution companies and pipelines, to bring gas to market more rapidly and more effectively.

I think we are going to have some real luck in introducing that later today. It takes a lot of time to get that thing finally done, but we have got this amazing coalition together, and if you have them all there you do it while you can.

As a general proposition, or just a general statement, as I outlined in the hearing that we had last year—we had a fascinating hearing, and some of you were here, in which the proponents and the opponents were here, and we had a very interesting discussion of reform.

As I pointed out at that time it reminded me very much of hearings that we had 15 years ago on the telephone company. You got the opponents of any kind of a change talking about the integrity of the system that will be badly compromised, and cross-subsidy problems that are going to exist, and access issues that are going to destroy the system, and more fragile financing will make the entity less viable.

All of those arguments were made, and I tend to be one that believes, as I did at that time, that newer technology benefits consumers, benefits the country, and generally it is a good thing to shake up the system. That, as a general proposition, is the right thing to do. If in fact you structure it properly and having the right structures and the right safeguards become the key to doing this.

So I have a couple of detailed questions I want to ask you about, if I might. One relates to cross-subsidy, and I would like to focus your attention on, if I might, Mr. Fleischman, and the other relates to the debt-equity issue that I have been asking a number of people about, and I would like to ask you about it if I might, Secretary Stuntz.

First of all, Mr. Fleischman, the cross-subsidy issue. If you look at the spaghetti chart that we have all been handed out—you have got it there. If you look at the box related to the exempt holding companies, those holding companies are not subject to the same regulation that you would bring to bear on this.

It seems to me that there is an issue as to whether or not States are able to effectively regulate rates in such a way that you do not get into a cross-subsidy issue where the exempt holding company is able to cross-subsidize in some fashion.

Obviously, cross-subsidies are one of the key issues if we are going to reform the Public Utility Holding Company Act to make sure that there are not unfair advantages that come from one place or another, where you are effectively using ratepayer revenues to subsidize the competitive entrant. That is always true in this kind of a regulatory change.

The question that I have is, do States have the authority—and you can tell me. I do not know—but do States have the authority to effectively preclude that kind of cross-subsidy? Do States have that authority? Do we have to do something more to provide them with that authority? I just do not know.

Mr. **Fleischman**. Some of the State commissions have been given that authority by their respective legislatures, Senator Wirth, and some have not.

Senator **Wirth**. What happens in the States that have not? Does that, then, raise a problem where we might end up with unfair cross-subsidies?

Mr. **Fleischman**. It could, Senator Wirth. The bills are different. Senator Johnston's bill and the bill introduced by the administration differ on this point, in terms of the extent to which the SEC retains a so-called "unless and except" capability to remove the exemption from a company that the SEC feels, on the basis of standards in the legislation, has crossed a line, but in fact we have heard testimony this morning from the Federal Energy Regulatory Commission that it feels it can handle the cross-subsidization problem. We at the SEC have no reason to doubt that.

Senator **Wirth**. Do you feel comfortable with that?

Mr. **Fleischman**. Yes.

Senator **Wirth**. You have so testified. I have great faith, as you know, in the SEC as I think a very careful and thoughtful regulator in the public interest, and if you all feel that way and kind of give that blessing, then that gives me a greater feeling of comfort.

Mr. **Fleischman**. Yes, we do, Senator Wirth.

Senator **Wirth**. Does anybody else want to comment on that?

The **Chairman**. If you would yield on that point, because I think this is a very vital issue, the question of authority of the States to regulate. A lot of the State legislatures have not conferred on the PUC's the authority to regulate cross-subsidy, have they?

Senator **Wirth**. That is one of the problems. Some have and some have not, I think is what Commissioner Fleischman was just suggesting.

The **Chairman**. I wondered. I do not think NARUC has weighed in on this. I would like to hear what they have to say about whether we ought to give a Federal right of the PUC's to do it—in other words, not wait for the State legislatures—or whether we ought to have the State legislatures do that, or whether we ought to do nothing at all.

I think this is really an important point, and I hope NARUC later will address that.

Senator **Wirth**. I appreciate the comment. I think that is one of the gut issues in all of this. I think if you assume that we can do it technically, that there is no harm to the system in the ratepayer cross-subsidy issue, then it becomes very fundamental in all of this, and that is why I think we ought to make sure that those safeguards are in line so we are not providing one advantage or disadvantage one way or another inadvertently. These independent consequences that pop up, we ought to anticipate. Do either of you have any thoughts on that?

Ms. **Stuntz**. Yes, Senator Wirth. The administration's bill was developed in close consultations with NARUC and others—not to intimate they have taken a position yet on it, they are still studying it. But we have basically, I think, as a Federal matter, determined that it is necessary to give States that ability on a generic basis.

That is why when there is an exempt holding company, now exempt under law, with an EWG subsidiary, the State would have to determine—the State wherein a retail utility is residing as an affiliate of that would have to determine—that they have available the means to detect any cross-subsidies or the exemption would be jeopardized, and we think that is a significant difference in our two bills and we think that is important from NARUC's perspective, and we believe they support that.

Senator WIRTH. You think that adequately provides the States with a legislature has not granted the direct authority, that it gives the commissions in those States the authority to do the job to avoid cross-subsidy?

Ms. STUNTZ. I believe that would.

Senator WIRTH. Ms. Marlette?

Ms. MARLETTE. Senator Wirth, I would also add that I had noted earlier that under 301 of the Federal Power Act the FERC has extensive authority to obtain accounts, records, documents of public utilities under our jurisdiction and of entities that they control, or that control them, and that the Commission also has authority to divulge that information where it is appropriate and in the public interest and that a State commission can indeed ask the Commission to divulge information if it needs it, for example, to protect against cross-subsidies, because I know that obtaining information is an important part of that, and the Commission has indeed in the past in certain circumstances granted requests of State commissions in that regard.

Senator WIRTH. Mr. Chairman, I hope we also hear from NARUC. I appreciate the comments of all of you and if you have any other comments that you might like to make for the record, I think it is an issue that we are going to be looking at in some detail in the committee as we look at this important piece of legislation.

In the time remaining to me, I had one other question, and I think maybe, Linda, you are the best source on this. Let me see if I can paint it properly and understand the issue.

If you have in a State a utility that is regulated under the authority of that State by the regulatory commission in that State, and that State says to the utility, you have got to have a debt-equity ratio of 50 percent—50/50. We believe that is important for the stability of the utility and we believe that that is a conservative regulation and an important thing to do.

So let us grant that that is the way that State regulates. You have an outside independent supplier of power coming into the State, and say we amend the Public Utility Holding Company Act and that outside supplier is allowed to come in and compete with that utility in terms of developing a source of power, that outside entity comes in with a debt-equity ratio of, say, 1 to 9—90 percent of its funding comes from debt—that means, as I understand debt and equity and the cost of debt and the cost of equity, that that outside supplier coming in has a very significant advantage over the regulated utility in that State. Debt is generally cheaper than equity.

If that is the case, what we are doing is, at a time when everybody is protesting that we want to have a level playing field, effectively what we are doing in that situation is weighting it for the outside competitor coming in against the regulated utility in that State. Even in that regulated utility in that State might want to compete, the regulated utility might say, I am perfectly capable of competing because I cannot do so because my State regulatory commission says I have to have a 50 percent equity base in any project that I undertake.

Now, it seems to me that if we make that change in the Public Utility Holding Company Act, what we are doing is tilting the playing field away from a utility that might be very productive and capable of doing all of the things that the outside vendor of power might be able to do, and that is unfairly tilting away from the State utility.

If the premises of that are correct—that debt is cheaper than equity, which I think it is—and that that might be one of the unintended consequences, the question might be, what is in the legislation, or what should be in the legislation that would tend to once again level the playing field?

Ms. STUNTZ. Your question goes back to one of the fundamental things that is hard to keep in mind, what we are doing and what we are not doing in this PUHCA reform bill.

We would not, for example, make that unlevel playing field. It would be because we do not require, number one, we do not require the States to do competitive procurement. It would be a State determination in the first instance, that it saw fit to have a competitive procurement occur in that State.

So since that is a State decision in the first place, the State would have had to decide that even though it wants its utilities, that it regulates by your example, to have 50 percent debt, 50 percent equity, it would nonetheless be all right not only to have competitive procurement, but to have power selected as a result of that competitive procurement have a substantially different debt/equity ratio.

And I think the key to that would be—I agree with you. I think that does not sound fair or equitable, but the key would be, it is not the PUHCA amendment that created that disparity, if you will. It is the judgment of the State regulators, for whatever reason, that even though the utilities they directly regulate ought to be 50/50, it is okay for an EWG to sell to that same utility at 90/10.

I find it difficult to think that that would happen. But it would be up to the States and not something that is created as a result of this legislation.

The CHAIRMAN. Would the Senator yield at that point?

Senator WIRTH. I would.

The CHAIRMAN. We did an in-house study, which I want to put in the record and make available to you and others on IPP's and registered and unregistered holding company utilities on their debt/equity ratios and on the effect that had on the cost of capital. What we found was that IPP's were all over the lot, some had a high cost of capital and some had a lower than utilities.

But on the average their cost of capital was not greater, I mean, was not less than utilities. It was pretty much comparable. We have got the figures here. So, if it were so that a higher debt/equity ratio gave you better cost of capital, then every corporation in America would have a 99/1 ratio. But it is not necessarily so. And that is what our study shows.

Now there is also an ability, I believe, that the States would have, if they chose to use, to regulate debt/equity ratios of EWG's which for the most part are not now regulated by the States with respect to debt/equity ratios. It does not show a difference in the cost of capital.

And I will put that study in the record and make it available to anybody that wants to see it.

[The information referred to follows:]

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510-6150

March 13, 1991

MEMORANDUM

TO: **Members and Energy Legislative Assistants**
Committee on Energy and Natural Resources

FROM: **William Conway, Senior Counsel**
Karl Hausker, Chief Economist

RE: Financial Issues in PUHCA Reform

Title XV of the National Energy Security Act of 1991 would remove the impediments to independent power production contained in the Public Utility Holding Company Act of 1935 (PUHCA). There are many complex financial issues entwined in the debate over PUHCA reform. Some of these issues relate to "debt leveraging", i.e., the use of high levels of debt by Non-Utility Generators (NUGs)[1]

This memorandum addresses five key financial questions related to the PUHCA debate:

(1) Why do NUGs use debt leveraging?

(2) Does debt leveraging lead to NUGs with unstable financial structures? Could debt leveraging by NUGs lead to unreliable electricity supplies?

(3) Does debt leveraging create a cost-of-capital advantage for a NUG when it competes with a utility to build new capacity?

(4) If a utility buys power from a NUG, does the utility become effectively more highly leveraged? Is this a hidden cost of NUG power?

(5) What happens to a utility's earnings as it buys more NUG power, and the utility's investment in generation declines?

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[1] "NUGs" refers to both independent power producers and Qualifying Facilities as defined in the Public Utility Regulatory Policies Act of 1978 (i.e., small power producers and cogenerators).

The memorandum concludes that:

1) The use of debt leveraging by NUGs is a natural outgrowth of the assets that underlie the debt and the contracts that NUGs enter into with utilities.

2) Debt leverage does not make NUGs financially unstable and has had no effect on the reliability of power production.

3) Debt leveraging does not appear to give a consistent or inherent competitive advantage to NUGs when they compete with utilities to build new capacity.

4) When a utility purchases power under a long-term contract from a NUG (or from another utility for that matter), the utility takes on a financial obligation that may resemble debt, but is not equivalent to debt. The effect of a power purchase contract on the utility's cost of capital is determined by a host of additional factors and depends for the most part on the degree to which the contract assigns risk to the NUG.

5) A utility heavily dependent on NUG power need not suffer any loss of earnings.

The remainder of this memorandum explores these questions in depth.

I. WHY DO NUGs USE DEBT LEVERAGING?

Virtually all businesses choose some mixture of debt and equity to raise capital for investment. A business raises capital in the form of debt by securing loans from banks or other investors. The payment of interest on the loans is the return on the debt holders' investment. The interest rate on loans is the "cost of debt". Any business that uses debt is "leveraged" to some degree.

A business raises capital in the form of equity by selling shares of stock to equity holders. The payment of dividends (and any appreciation in stock price) constitutes the return on the equity holders' investment. The minimum acceptable level of return on equity (expressed as a percentage) is the "cost of equity". A business must meet its obligations to debt holders before it can pay dividends to its equity holders. The overall "cost of capital" to a business is the weighted average of its cost of debt and its cost of equity. The lower the cost of capital, the better the business is able to compete.

Businesses use leverage to varying degrees, and financial theory cannot fully explain the observed mixtures of debt and equity among various companies. Conventional wisdom holds that debt is generally preferable to equity because the interest on debt is a tax- deductible expense, whereas the dividend paid to equity holders is not. Therefore, a business makes decisions based on the "after tax" cost of debt which is lower because it reflects this tax-deductibility. If one could hold all else equal, as a business used more debt, its cost of capital would decrease. In the real world, however, one cannot hold all else equal. If a business takes on more debt, this tends to: 1) increase the risk of defaulting on debt payments, and 2) increase the uncertainty and variability of returns to equity. This drives up the cost of both debt and equity, and thus drives up the overall cost of capital.

Some financial analysts believe that a business tries to minimize its overall cost of capital by finding the right balance of debt and equity -- a balance that reflects the benefits of debt (tax deductibility of interest) with the disadvantages of debt (increased cost of debt and equity). The best balance of debt and equity for a particular business depends partly on the stability of the business' revenues. The more stable the revenues, the more debt the business can take on (yet still assure its lenders of repayment). The best balance of debt and equity also depends on what would happen to the assets of the business in the event of financial difficulty. If those assets are "tangible" (i.e., if they can continue to generate cash, or can be sold easily under a business reorganization), then lenders are usually willing to allow the business to take on relatively high levels of debt.

Alyeska, the operator of the Trans-Alaska Pipeline, is an example of a highly leveraged business. It has stable revenues resulting from throughput agreements with oil companies. It also has very tangible assets that would retain their value in case of financial difficulty. At the opposite extreme are service businesses such as law, accounting, and consulting firms. They typically have low levels of debt, reflecting the fact that their revenues are highly variable, and their assets are individual people who cannot be sold or transferred in the event of financial difficulty.

A typical electric utility has a capital structure with about 50% debt and 50% equity. This reflects the fact that utilities have very tangible assets, yet their earnings can vary substantially with changes in sales or regulatory policy.

NUGs generally have a capital structure with 80 to 90 percent debt. This reflects the fact that NUGs (like utilities) have tangible assets in the form of a power plant. Most importantly, a NUG typically has a long-term power contract with a utility that assures stable revenues for the NUG. One can assume that NUGs, like other businesses, seek a degree of debt leverage that minimizes their overall cost of capital. Keep in mind, however, that a NUG cannot simply choose its degree of debt leverage; the NUG can achieve it only if a lender views the business as secure enough to make the loan.

II. DOES DEBT LEVERAGING LEAD TO NUGs WITH UNSTABLE FINANCIAL STRUCTURES? COULD DEBT LEVERAGING BY NUGs LEAD TO UNRELIABLE ELECTRICITY SUPPLIES?

Some opponents of PUHCA reform argue that debt leveraging leads to NUGs with unstable financial structures, and thus could lead to unreliable electricity supplies. Vague analogies have been made to the savings and loan (S&L) institution crisis, the leveraged buy-outs and junk bonds of the 1980's, and the financial sleight-of-hand that occurred in the 1920's prior to effective regulation of the financial markets. Apparently the fear is that NUGs will face financial collapse because they will be unable to service their debt at some future time.

There is no evident basis for this fear. NUGs are not fooling their bankers into lending them inordinate amounts of money at high risk. As discussed above, NUGs can take on high levels of debt because: 1) they invest in a tangible asset (a power plant), and 2) they have long-term power sales contracts with utilities.

Empirically, NUGs have proved highly reliable. They have excellent operating records. There has been no apparent detrimental effect from leveraging. They can withstand changes in fuel prices because either they have long-term fuel contracts, or their selling price has been indexed to the price of fuel (just as a utility's revenue requirement is often adjusted to reflect changes in fuel prices).

The loan practices that led to the S&L crisis are irrelevant to the question of NUG leveraging. Many S&L's behaved irresponsibly because they seemed to face no financial risks for poor investments. These risks were borne by the Federal deposit insurance system (i.e., the taxpayer). Regulatory agencies were understaffed and were not capable of serving as a substitute for the discipline of the financial markets. In contrast, debt holders and equity holders in NUG projects do bear the risk of project failure, and have every incentive to make wise and prudent investments.

Leveraged buy-outs financed by junk bonds were popular in the 1980's. Clearly, some firms took on excessive levels of debt and are now paying the price as the economy weakens. Once again, the practice of junk-bond financing is essentially irrelevant to NUG financing. Junk bonds typically paid extremely high interest rates and did not have any stable source of revenues to pay off the bonds. The debt incurred by NUGs typically carries only a slightly higher interest rate than utility debt, and is backed by power sale revenues under a contract with a utility.

Some opponents have criticized NUGs on the grounds that leveraging was one of the practices that led to the enactment of

PUHCA. However, the leveraging that concerned Congress in PUHCA was considerably different from leveraging by NUGs. In 1935, control of the electric utility industry was concentrated in a small number of holding companies. These companies were built in part through the use of leveraged capital structures at the holding company level, rather than the operating level, as in the case of NUGs. Eventually, many of these holding companies collapsed because their leverage was not supported by underlying asset values. Congress' resulting concern is made clear in the findings section of PUHCA. It states that the interests of investors and consumers are harmed when:

> [S]ecurities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies.2/

NUGs simply do not engage in this kind of leveraging. They have the solid asset of a power plant and a solid contract ensuring steady revenue.

III. DOES DEBT LEVERAGING CREATE A COST-OF-CAPITAL ADVANTAGE FOR A NUG WHEN IT COMPETES WITH A UTILITY TO BUILD NEW CAPACITY?

The question of whether leveraging creates a competitive advantage for NUGs is explored in depth in an analysis attached to this memo. The analysis approaches the question from the perspective of financial theory and from two empirical perspectives: by examining the actual cost of capital for utilities and NUGs, and by simulating a competitive bid between a utility and a NUG. The analysis indicates that the use of leveraging may confer a cost advantage to the NUG in some instances, but that the advantage is neither consistent nor inherent.

IV. IF A UTILITY BUYS POWER FROM A NUG, DOES THE UTILITY BECOME, IN EFFECT, MORE HIGHLY LEVERAGED? IS THIS A HIDDEN COST OF NUG POWER?

Another concern regarding NUG power purchases is the notion that such purchases are equivalent to adding debt to the utility's capital structure. If true, this could raise the utility's cost of capital and, hence, its revenue requirement. However, the evidence does not support this argument.

2/ Section 1(b)(1), Public Utility Holding Company Act of 1935.

The two major rating agencies, Moody's and Standard and Poor's, have done analyses of the financial implications of long term power purchases by utilities. Moody's concludes that it will look beyond ordinary debt in assessing a company's fixed obligations, and that:

> [T]he practice of imputing debt obligations for purchased power contracts constitutes a better measurement of the real financial burden being undertaken by the [purchasing utility] company."3/

Standard and Poor's takes a somewhat different position:

> Because these [purchased power] obligations are less firm [than debt], S&P does not simply treat them as debt equivalents.4/

The approach taken by Standard and Poor's appears more reasonable. Debt is a noncontingent obligation to repay a loan with interest, whereas the typical NUG contract is a contingent obligation to pay only if power is produced.5/ Thus, a NUG power contract is not equivalent to debt.

Nevertheless, both ratings agencies agree that the fixed payment obligations associated with a long-term power purchase contract may reduce the purchasing utility's financial flexibility (i.e. cash flow committed to pay for purchased power is unavailable for unforeseen contingencies). However, this effect is a function of the contract itself. It has nothing to do with whether the seller under the contract is a NUG or is leveraged. The same concern exists with respect to a long term power contract between two utilities.

3/ "Purchased Power Commitments and Their Impacts on Investor-Owned Electric Utility Credit Quality", Moody's Special Comment (August 1990), p.6.

4/ "Utilities' Risks in Purchasing Power", Standard & Poor's Credit Week (March 26, 1990), p.2.

5/ For purposes of comparison, some power contracts between utilities obligate the purchaser to make payments regardless of the actual availability of power. These are frequently referred to as "hell or high water" or "take or pay" contracts. (Recall the unending "take or pay" debacle in the gas industry.) "Take or pay" contracts are, in fact, nearly equivalent to debt. The contracts that NUGs have entered into are generally referred to as "take and pay" or "performance" contracts. These simple but fundamental differences in contracts are often overlooked, adding confusion to the issue.

More importantly, reduction in financial flexibility is only one of a host of costs and benefits that the rating agencies will examine in determining the effect of a power purchase contract with a NUG on a utility's credit worthiness. In general terms, the agencies evaluate a contract on the basis of whether, and to what extent, it allows the utility purchaser to shift significant risks to the seller (such as the risk of construction or operation of a plant). Both rating agencies explicitly recognize that a power contract with a NUG may offer either a significant benefit or a significant detriment to the purchasing utility. The answer in any given circumstance will depend for the most part upon what the contract provides. Examples of factors that the rating agencies look at include whether the NUG is dispatchable, whether it contributes to fuel diversity, and whether the operator has a previous track record.

V. WHAT HAPPENS TO A UTILITY'S EARNINGS AS IT BUYS MORE NUG POWER, AND THE UTILITY'S INVESTMENT IN GENERATION DECLINES?

Some observers have noted the potential long term effect of a utility purchasing power rather than building new generation. Under conventional ratemaking practices, the cost of wholesale purchased power is passed through to ratepayers without mark-up, whereas a utility earns a rate of return on capital invested when it builds its own plant. In addition, the amount of capital a utility has invested at any given point (rate base) is gradually reduced through depreciation. Thus, over time a utility's earnings per share could decline to the extent that it exclusively purchases power and does not construct its own new generation or make other capital investment.

Fears of this result appear overblown. The problem of declining rate base is at most a gradual phenomenon, and it unreasonably assumes the worst case (no utility construction). In reality state utility commissions are likely to adopt a "portfolio" approach to power supply in which utility generation does play a part, and utilities do not become completely dependent upon purchased power. Moreover, utilities must at least make periodic capital investment in transmission and distribution, even if they do not do so with respect to generation.

In the unlikely event that a state commission's policies result in effective preclusion of further utility investment in generation, there are numerous ways in which the declining rate base problem could be addressed. The state commission could:

-- recognize declining rate base as a "cost" to the utility for purposes of evening up the comparison between utility generation and purchased power.

-- modify the pass-through aspect of purchased power and allow some sort of mark-up as a way of rewarding intelligent power procurement. (This change would seem to be a logical outgrowth of the concept of integrated resource or least cost planning.)

-- allow the utility to take advantage of leveraging by forming a NUG which would sell power back to the utility under cost-of-service regulation (and thus mitigate any problem of self-dealing).

Finally, a utility that finds its rate base declining can simply use the cash flow generated by depreciation to buy back its own common stock and debt.[6] This practice has the effect of shrinking the size of the utility, but it maintains the amount of earnings per share. Buy-back is apparently a common practice for utilities today when cash flow from depreciation is not needed to finance new capital investment.

In summary, the declining rate base problem is neither likely to occur, nor insoluble if it does.

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[6] Utilities recover depreciation in their rates as an expense.

ANALYSIS OF DEBT LEVERAGING BY IPPs

One key issue in the debate over PUHCA reform involves debt leveraging by Independent Power Producers (IPPs). Some opponents of PUHCA reform argue that debt leveraging creates an unfair advantage for a IPP when it competes with a utility to build new capacity. They argue that debt leveraging gives an IPP a lower cost of capital than a utility, and that the utility cannot use debt leveraging to match this. They argue that this advantage will allow IPPs to build much of the new capacity needed to demand, even though IPP power may be more costly.

This paper examines this argument and reviews the evidence. The analysis approaches the question from the perspective of financial theory and from two empirical perspectives: 1) by comparing a range of actual costs of capital for utilities and NUGs, and 2) by simulating a competitive bid between a utility and a NUG. The analysis indicates that leveraging may confer a cost advantage to the NUG in some instances, but that the advantage is neither consistent nor inherent. In some cases, IPPs have a higher cost of capital than utilities.

This analysis indicates that one cannot argue against PUHCA reform on the basis that debt leveraging gives a IPPs an unfair competitive advantage.

Financial Theory and Leveraging

Electric utilities typically have capital structures of about 50% debt and 50% equity. IPPs use debt in the 80 - 90 percent range or even higher. Because interest on debt is tax-deductible, some have argued that debt leveraging lowers the IPP's cost of capital, and creates an unfair advantage over a utility. The question can be stated as follows: If an IPP can build a plant for the same cost as a utility (under cost-of-service regulation), will the IPP be able to bid under the utility's avoided cost solely because of it can use higher debt leverage?

Financial theory is ambiguous on whether leveraging increases the value and profitability of a firm. One school of thought maintains that the value of a firm is quite independent of its capital structure. This school would argue that a firm cannot simply swap debt for equity and thus benefit from the tax-deductibility of interest. Instead, the cost of both equity and debt rise as leveraging increases. Another school maintains that debt is always cheaper than equity. Firms should borrow as long as lenders view the loans as "low risk". According to this view, there are optimal capital structures for different types of firms. Optimal capital structures would be determined by the

relative certainty of a firm's earnings and the tangibility of its assets.

Evidence: Weighted Average Cost of Capital

One empirical approach to the question at hand is to compare the Weighted Average Cost of Capital (WACC) for a utility and an IPP. WACC is a shorthand way of measuring how much it costs a firm to raise money for investment. It accounts for the mix of debt and equity, the profits that equity holders demand, the interest that debt holders demand, and the tax-deductibility of that interest.

Currently, utility stockholders require a return of 12 - 13 percent on their investment; bondholders require interest rates of about 9 - 10 percent. A plausible range for a utility's WACC is 9.3 to 9.5 percent. Given that IPPs are unregulated firms facing higher risks, stockholders require higher returns on the order of 15 - 20 percent. IPP bondholders also require higher interest rates in the 10 to 11 percent range. A plausible range for an IPP's WACC is 7.4 to 9.8 percent. These numbers are derived in detail in Table 1.

The comparison of WACCs indicates that some IPP's may have a cost of capital advantage over utilities, but that this advantage is not consistent or inherent. Moreover, a simple comparison of WACCs can be misleading. First of all, the WACC does not reflect the length of the loans to the two types of firms. Utilities can borrow for up to 30 years; IPPs typically borrow for 15-20 years. The fact that IPPs must repay debt over a shorter period makes them less competitive, holding all else constant. Second, the 80-90 percent debt financing of the IPP may underestimate the equity committed to the project. For example, equipment vendors may be forced to pay for construction cost overruns or make compensation if performance falls below specifications.

Evidence: Cash Flow Model

Given the simplicity and drawbacks of a simple WACC comparison, a more sophisticated analytic approach to the debt leverage question is needed. Committee staff developed a cash flow model that can simulate, in effect, a competitive bid between a utility and an IPP, while accounting for the fact that IPPs borrow for shorter terms. Tables 2 and 3 gives a sample output from the model.

The model begins by calculating a utility's revenue requirement for a plant costing $1000 (Table 2). An IPP attempts to compete with this plant. The IPP has the same fuel and O&M costs as the utility and bids a price component perfectly indexed to these costs. The IPP can build the identical plant for $1000 with its leveraged capital structure. The utility pays its "avoided capital cost" to the IPP in the form of any of several payment streams with a present value equal to the present value of the revenue requirement for the same plant. The model calculates the IPP's cash flows, coverage ratios, and return on equity for the payment streams (Table 3). If the IPP earns a return on equity higher than it's 15 - 20 percent minimum, then one can conclude that the IPP can underbid the utility (i.e., offer a price lower than avoided cost).

As was the case with WACC calculations, there is no one set of correct inputs for the this model, thus, various plausible sets of inputs have been used. The model indicates that in some cases the IPP could underbid the utility, but once again, this is not a consistent or inherent result. The model also shows that leveraging can increase an IPP's return on equity, but often the IPP would have trouble obtaining financing in the face of negative cash flow and poor coverage ratios (i.e., the ratio of revenue to loan payment).

TABLE 1 - COMPARISON OF UTILITY AND IPP WEIGHTED COST OF CAPITAL (WACC)

The table below derives the WACC for a utility and an IPP with various capital structures. Three utility cases are given for Moody's ratings of AA, A, and Baa, respectively. The costs of long-term debt and preferred stock are 1990 averages for each rating category. The utility cost of equity is the average for 1990 (separate figures not available for different ratings). The shares of equity, preferred stock, and debt are the current averages for the industry as reported by EEI.

Three IPP cases are given: low, medium, and high. The cost of equity ranges from 15 to 20 percent; the cost of debt ranges from 10 to 11. The debt share ranges from 80 to 90 percent. These figures are based on discussions with investment bankers familiar with IPP financing. (IPPs do not issue preferred stock.)

The pre-tax WACC is the weighted average of the cost of the three (or two) capital cost components. The after-tax WACC is computed the same way except the cost of debt is reduced by one minus the tax rate. The pre-tax return is a another perspective on the cost of capital. It is computing by "grossing up" the necessary return on equity and preferred stock by dividing by one minus the tax rate. The after-tax WACC for the utility ranges between 9.3 and 9.4. The after-tax WACC for the IPP ranges between 7.4 and 9.8. Both after-tax WACC and the pre-tax return comparison indicate that an IPP can have a cost of capital as much as 21% less, or as much as 4% more, than that of a utility.

Corp Tax Rate = 34%

	COST OF EQUITY	EQUITY SHARE	COST OF PREF'D	PREF'D SHARE	COST OF DEBT	DEBT SHARE	==== WACC ===== PRE-TAX	AFTER-TAX	PRE-TAX RETURN
UTIL AA	12.7	42.8	9.1	7.4	9.7	49.8	10.9	9.3	14.1
UTIL A	12.7	42.8	9.5	7.4	9.9	49.8	11.1	9.4	14.2
UTIL Baa	12.7	42.8	9.6	7.4	10.1	49.8	11.2	9.5	14.3
IPP low	15.0	10.0			10.0	90.0	10.5	7.4	11.3
IPP med	17.5	15.0			10.5	85.0	11.6	8.5	12.9
IPP high	20.0	20.0			11.0	80.0	12.8	9.8	14.9

TABLE 2

SENATE ENERGY COMMITTEE - DEBT LEVERAGING ANALYSIS

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CASE:GENERIC PLANT                    SPREADSHEET TO CALCULATE CAPITAL CHARGE REVENUE REQUIREMENTS                      INPUT DATA PAGE

  BOOK LIFE      30 YRS (CHOOSE =< 30)      PLANT IN SERVICE YEAR          1991      CAPITAL COST:  DIRECT   1000.00 MILLIONS
  TAX LIFE       20 YRS (CHOOSE =< 30)      FULL-YR(=1) OR MID-YR(=0)         1                     AFDC        0.00 MILLIONS
  DEPR METH       1 (CHOOSE 1 - 8)          $$ UNITS(MIL=0 PER KW=1)          0                     TOTAL    1000.00 MILLIONS
  DB FACTOR     150%                        REVENUE TAX RATE              0.00%                     ITC         0.00 MILLIONS
  INCOME TAX RATE                           PROPERTY TAX & INSURANCE      0.00% OF BV YR   ITC BASIS REDUCTION FOR TAX DEPRECIATION    0.00 MILLIONS
   FEDERAL     34.00%                                                                      AFDC DEBT TAX BENEFITS NOT FLOWED THROUGH    0.00 MILLIONS
   STATE        0.00%         % OF THE DEFERRED TAX RESERVE NETTED FROM RATE BASE([illegible]%)
   NET         34.00% (F+S-F*S)  UNAMORTIZED ITCs NETTED FROM RATE BASE (0=NO 1=YES)    0

  ** LEVELIZED REVENUE REQUIREMENT [illegible] (years) **
```

YEAR	DEBT RATIO	PREFERRD RATIO	EQUITY RATIO	TOTAL	DEBT COST	PREFERRD COST	EQUITY COST	WACC	ANNUITY FACTOR
1991	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	1.000
1992	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	1.900
1993	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	2.711
1994	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	3.441
1995	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	4.098
1996	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	4.690
1997	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	5.222
1998	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	5.702
1999	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	6.134
2000	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	6.522
2001	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	6.872
2002	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	7.187
2003	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	7.471
2004	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	7.727
2005	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	7.957
2006	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	8.164
2007	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	8.350
2008	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	8.518
2009	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	8.669
2010	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	8.805
2011	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	8.928
2012	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.030
2013	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.137
2014	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.227
2015	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.307
2016	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.380
2017	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.445
2018	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.504
2019	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.557
2020	0.498	0.074	0.428	1.00	9.90%	9.50%	12.70%	11.07%	9.604

TAX DEPRECIATION METHOD

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	DB DEPRC SCHED	1986 TAX REFORM TAX DEPREC SCHEDULES			RETROSPECTIVE ACRS TAX DEPREC SCHEDULES			INPUT DEPRC SCHED
YEAR		10 YR	15 YR	20 YR	5 YR	10 YR	15 YR	
1991	0.075	0.150	0.100	0.075	0.150	0.080	0.050	0.070
1992	0.069	0.128	0.090	0.069	0.220	0.140	0.100	0.120
1993	0.064	0.108	0.081	0.064	0.210	0.120	0.090	0.120
1994	0.059	0.092	0.073	0.059	0.210	0.100	0.080	0.110
1995	0.055	0.087	0.066	0.055	0.210	0.100	0.070	0.100
1996	0.051	0.087	0.059	0.051		0.100	0.070	0.090
1997	0.047	0.087	0.059	0.047		0.090	0.060	0.080
1998	0.045	0.087	0.059	0.045		0.090	0.060	0.070
1999	0.045	0.087	0.059	0.045		0.090	0.060	0.060
2000	0.045	0.087	0.059	0.045		0.090	0.060	0.050
2001	0.045		0.059	0.045			0.060	0.040
2002	0.045		0.059	0.045			0.060	0.030
2003	0.045		0.058	0.045			0.060	0.030
2004	0.045		0.059	0.045			0.060	0.020
2005	0.045		0.059	0.045			0.060	0.010
2006	0.045			0.045				0.000
2007	0.045			0.045				0.000
2008	0.045			0.045				0.000
2009	0.045			0.045				0.000
2010	0.045			0.045				0.000
2011	0.000							0.000
2012	0.000							0.000
2013	0.000							0.000
2014	0.000							0.000
2015	0.000							0.000
2016	0.000							0.000
2017	0.000							0.000
2018	0.000							0.000
2019	0.000							0.000
2020	0.000							0.000

TABLE 2 (cont.)

SENATE ENERGY COMMITTEE - DEBT LEVERAGING ANALYSIS

CASE:GENERIC PLANT

SPREADSHEET TO CALCULATE CAPITAL CHARGE REVENUE REQUIREMENTS

OUTPUT DATA PAGE

$ MILLIONS

YEAR	BOY BOOK VALUE TOTAL	BOOK DEPR ON TOTAL	BOY TAX VALUE TOTAL	ADR TAX DEP	SL TAX DEP	DEFERRED INCOME TAXES	AFDC DEBT AMORT	BOY DEFERRED TAX RESERVE	ITC AMORT	AVERAGE YEARLY RATE BASE	DEBT RETURN	PREFERRED RETURN	COMMON RETURN	TAXABLE INCOME	TAXES PAID	REQUIRED REVENUE	1991 PV OF REQUIRED REVENUE	1991 CUMLATVE PV OF REQUIRED REVENUE	LEVLIZED REV REQ THROUGH THIS YEAR
1991	1000.00	33.33	1000.00	75.00	33.33	14.17	0.00	0.00	0.00	976.25	48.13	6.86	53.07	49.13	16.71	172.26	172.26	172.26	172.26
1992	966.67	33.33	925.00	69.38	33.33	12.25	0.00	14.17	0.00	929.71	45.84	6.54	50.54	50.43	17.15	165.64	149.13	321.40	169.13
1993	933.33	33.33	855.63	64.17	33.33	10.49	0.00	26.42	0.00	885.00	43.63	6.22	48.11	51.47	17.50	159.28	129.11	450.51	166.18
1994	900.00	33.33	791.45	59.36	33.33	8.85	0.00	36.91	0.00	842.00	41.51	5.92	45.77	52.29	17.78	153.16	111.70	562.29	163.42
1995	866.67	33.33	732.09	54.91	33.33	7.34	0.00	45.75	0.00	800.58	39.47	5.63	43.52	52.89	17.98	147.26	96.77	659.06	160.83
1996	833.33	33.33	677.19	50.79	33.33	5.93	0.00	53.09	0.00	760.61	37.50	5.35	41.34	53.29	18.12	141.58	83.76	742.82	158.40
1997	800.00	33.33	626.40	46.98	33.33	4.64	0.00	59.02	0.00	721.99	35.60	5.08	39.24	53.50	18.19	136.08	72.48	815.30	156.12
1998	766.67	33.33	579.42	44.57	33.33	3.82	0.00	63.66	0.00	684.43	33.74	4.81	37.20	52.42	17.82	130.73	62.70	878.00	153.99
1999	733.33	33.33	534.85	44.57	33.33	3.82	0.00	67.49	0.00	647.27	31.91	4.55	35.18	48.96	16.65	125.45	54.17	932.17	151.98
2000	700.00	33.33	490.28	44.57	33.33	3.82	0.00	71.31	0.00	610.12	30.08	4.29	33.16	45.51	15.47	120.16	46.71	978.88	150.08
2001	666.67	33.33	445.71	44.57	33.33	3.82	0.00	75.13	0.00	572.96	28.25	4.03	31.14	42.05	14.30	114.87	40.21	1019.09	148.29
2002	633.33	33.33	401.14	44.57	33.33	3.82	0.00	78.95	0.00	535.81	26.42	3.77	29.12	38.60	13.12	109.58	34.53	1053.62	146.59
2003	600.00	33.33	356.57	44.57	33.33	3.82	0.00	82.77	0.00	498.66	24.58	3.51	27.10	35.14	11.95	104.30	29.59	1083.21	144.98
2004	566.67	33.33	311.99	44.57	33.33	3.82	0.00	86.59	0.00	461.50	22.75	3.24	25.09	31.69	10.77	99.01	25.29	1108.50	143.47
2005	533.33	33.33	267.42	44.57	33.33	3.82	0.00	90.41	0.00	424.35	20.92	2.98	23.07	28.23	9.60	93.72	21.56	1130.06	142.03
2006	500.00	33.33	222.85	44.57	33.33	3.82	0.00	94.23	0.00	387.19	19.09	2.72	21.05	24.78	8.42	88.44	18.31	1148.37	140.67
2007	466.67	33.33	178.28	44.57	33.33	3.82	0.00	98.05	0.00	350.04	17.26	2.46	19.03	21.32	7.25	83.15	15.50	1163.87	139.38
2008	433.33	33.33	133.71	44.57	33.33	3.82	0.00	101.87	0.00	312.89	15.43	2.20	17.01	17.86	6.07	77.86	13.07	1176.94	138.17
2009	400.00	33.33	89.14	44.57	33.33	3.82	0.00	105.69	0.00	275.73	13.59	1.94	14.99	14.41	4.90	72.57	10.97	1187.91	137.03
2010	366.67	33.33	44.57	44.57	33.33	3.82	0.00	109.51	0.00	238.58	11.76	1.68	12.97	10.95	3.72	67.29	9.16	1197.06	135.95
2011	333.33	33.33	0.00	0.00	33.33	-11.33	0.00	113.33	0.00	209.00	10.30	1.47	11.36	52.77	17.94	63.08	7.73	1204.79	134.95
2012	300.00	33.33	0.00	0.00	33.33	-11.33	0.00	102.00	0.00	187.00	9.22	1.31	10.16	50.73	17.25	59.95	6.61	1211.40	134.04
2013	266.67	33.33	0.00	0.00	33.33	-11.33	0.00	90.67	0.00	165.00	8.13	1.16	8.97	48.68	16.55	56.81	5.64	1217.04	133.20
2014	233.33	33.33	0.00	0.00	33.33	-11.33	0.00	79.33	0.00	143.00	7.05	1.01	7.77	46.63	15.86	53.68	4.80	1221.84	132.43
2015	200.00	33.33	0.00	0.00	33.33	-11.33	0.00	68.00	0.00	121.00	5.97	0.85	6.58	44.59	15.16	50.55	4.07	1225.91	131.72
2016	166.67	33.33	0.00	0.00	33.33	-11.33	0.00	56.67	0.00	99.00	4.88	0.70	5.38	42.54	14.46	47.42	3.44	1229.35	131.07
2017	133.33	33.33	0.00	0.00	33.33	-11.33	0.00	45.33	0.00	77.00	3.80	0.54	4.19	40.50	13.77	44.29	2.89	1232.24	130.47
2018	100.00	33.33	0.00	0.00	33.33	-11.33	0.00	34.00	0.00	55.00	2.71	0.39	2.99	38.45	13.07	41.16	2.42	1234.66	129.91
2019	66.67	33.33	0.00	0.00	33.33	-11.33	0.00	22.67	0.00	33.00	1.63	0.23	1.79	36.40	12.38	38.03	2.01	1236.67	129.41
2020	33.33	33.33	0.00	0.00	33.33	-11.33	0.00	11.33	0.00	11.00	0.54	0.08	0.60	34.36	11.68	34.90	1.66	1238.33	128.94

TABLE 3

SENATE ENERGY COMMITTEE - DEBT LEVERAGING ANALYSIS

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IPP FINANCES                 Contract = 20 or 30 yrs             NOTES. Model examines capital costs only, as if the IPP had a price
** Assumptions **                                DB DEPR    150%        component that covered, and was indexed to, fuel & O&M costs.
CAP COST   $1,000                                TAX LIFE    20 yrs     The IPP can bid a capacity price equal to the utility's revenue
HURDLE %        15% [affects cont. to op.]       TAX RATE    34%        requirement on a present value basis.  The price stream
PRICING          2  [1=RR;2=nom lvl;3=wgt'd;4=real lvl]                 can be set at any of the four options below.
           Percent   Dollar     Loan Interest    Loan                   The IPP's ability to secure financing is dependent on its IRR,
             Share   Amount     Term     Rate  Payment                  minimum cash flows, and debt coverage ratios.  If the IPP earns
EQUITY         20%      200      n/a      n/a      n/a                  ROE > its hurdle rate, it can probably underbid the utility.
SR DEBT        80%      800       20    10.0%       94
JR DEBT         0%        0       15     0.0%        0           PRICING  1:price=rev. req. stream. 2:price=nominal levelized r.r.
** Summary of Results **                                                3:price=weighted version of 2&4. 4:real levelized r.r.
          20 YEARS 30 YEARS          MIN CASH FLOW           9          See separate pricing assumption section below.
IRR            16%      14%          MIN COVERAGE RATIO   1.37
NPV@IRR          0        0          CONT. TO OPERATE?       0 (0=yes 1=no.  Yes means NPV>0 (at hurdle rate) for all years)
```

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
JR OLD BALANCE		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
INTEREST		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
PRINCIPAL		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
JR NEW BALANCE		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SR OLD BALANCE		800	786	771	754	735	715	692	667	640	610	577	541	501	457	409
INTEREST		80	79	77	75	74	71	69	67	64	61	58	54	50	46	41
PRINCIPAL		14	15	17	19	20	22	25	27	30	33	36	40	44	48	53
SR NEW BALANCE		786	771	754	735	715	692	667	640	610	577	541	501	457	409	356
DEPR FACTOR		0.075	0.069	0.064	0.059	0.055	0.051	0.047	0.045	0.045	0.045	0.045	0.045	0.045	0.045	0.045
REVENUES		129	129	129	129	129	129	129	129	129	129	129	129	129	129	129
- TOTAL INTEREST		80	79	77	75	74	71	69	67	64	61	58	54	50	46	41
- DEPRECIATION		75	69	64	59	55	51	47	45	45	45	45	45	45	45	45
TAXABLE INCOME		-26	-19	-12	-6	1	7	13	18	20	23	27	30	34	38	43
TAXES		-9	-6	-4	-2	0	2	4	6	7	8	9	10	12	13	15
AFTER-TAX CASH FLOW	-200	44	41	39	37	35	33	31	29	28	27	26	25	23	22	20
CONT. TO OPERATE?		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
P&I COVERAGE		1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37	1.37

PRICE STREAM CALCULATIONS

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           LVL-REAL  LVL-NOM
WEIGHTS         0.5      0.5      #YRS       30 [for capital charge calc below]
INFL           4.0%               CC-YR1  0.082 [from EPRI Rate Study, p.2-6, Carrying Charge formula for yr 1 for levelized real charge]
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	NPV	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
NORMAL RR	1115	172	166	159	153	147	142	136	131	125	120	115	110	104	99	94
LEVEL RR	1115	129	129	129	129	129	129	129	129	129	129	129	129	129	129	129
WEIGHTED	1115	110	112	114	116	118	120	122	125	127	130	132	135	138	141	144
REAL LVL	1115	92	95	99	103	107	111	116	120	125	130	136	141	147	153	159

TABLE 3 (cont.)

SENATE ENERGY COMMITTEE - DEBT LEVERAGING ANALYSIS

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
JR OLD BALANCE	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
INTEREST	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
PRINCIPAL	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
JR NEW BALANCE	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SR OLD BALANCE	356	298	234	163	85	0	0	0	0	0	0	0	0	0	0
INTEREST	36	30	23	16	9	0	0	0	0	0	0	0	0	0	0
PRINCIPAL	58	64	71	78	85	0	0	0	0	0	0	0	0	0	0
SR NEW BALANCE	298	234	163	85	0	0	0	0	0	0	0	0	0	0	0
DEPR FACTOR	0.045	0.045	0.045	0.045	0.045	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
REVENUES	129	129	129	129	129	129	129	129	129	129	129	129	129	129	129
- TOTAL INTEREST	36	30	23	16	9	0	0	0	0	0	0	0	0	0	0
- DEPRECIATION	45	45	45	45	45	0	0	0	0	0	0	0	0	0	0
TAXABLE INCOME	49	55	61	68	76	129	129	129	129	129	129	129	129	129	129
TAXES	17	19	21	23	26	44	44	44	44	44	44	44	44	44	44
AFTER-TAX CASH FLOW	18	16	14	12	9	85	85	85	85	85	85	85	85	85	85
CONT. TO OPERATE?	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
P&I COVERAGE	1.37	1.37	1.37	1.37	1.37	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
NORMAL RR	88	83	78	73	67	63	60	57	54	51	47	44	41	38	35
LEVEL RR	129	129	129	129	129	129	129	129	129	129	129	129	129	129	129
WEIGHTED	147	150	154	157	161	165	169	173	177	182	186	191	196	202	207
REAL LVL	165	171	178	185	193	201	209	217	226	235	244	254	264	275	285

Senator WIRTH. I think it would also be helpful to put in the records, Mr. Chairman, the analysis done by the Department of Energy on this issue, which I also found, while helpful, I did not find it persuasive and I did not find the committee staff's study persuasive either. I think the question still remains. I read them both over the weekend. And I found them both, I found myself still having that question after I had read those two studies.

Ms. STUNTZ. I think I agree with the study. And I agree with, you know, it seems to me the key is do the States have an ability to protect consumers against whatever risks you might think occurred from different leveraging. Are we subjecting someone to unnecessarily, by this legislation, to a non-level playing field. And I do not think that is the case.

Senator WIRTH. Well, I can see you would be subjecting them to a non-level playing field because having the opportunity for IPP's to come in and sell power which would be at lower cost, there should be enormous consumer pressure on the State Public Utility Commission to go with the lower cost. I mean, that is one of the whole purposes of this.

And once you have the potential of lower costs coming in, then the State regulatory commission turns around and says, well, you have to buy at lower cost because that is beneficial to the consumer. Fine. But we are leaving the utility high and dry.

I mean, we may have one of the unintended consequences of, in fact, forcing the utility to buy that cheaper power and not being able to compete against it by the very nature of the changes. And that is a possibility, it seems to me.

And so, therefore, it seems to me we ought to think of a way in which we solve that problem going in so you do not end up with potentially that kind of a situation.

I hear what you are saying theoretically, but practically I can see that that problem could exist there. And I would appreciate maybe this is how many angels can dance on the head of a pin. But I still have not been satisfied in getting an answer to this. And I have been working on it.

I would appreciate any further analysis or thought, and more importantly, any suggestions that the Department might have as to how we might solve this problem.

Should there be additional language added that waives what a State can do or waives what a regulated utility can do? I do not know.

Ms. STUNTZ. I can just add we would be pleased to address that for the record.

But I would like to add one more thought today because I believe you will be hearing from a witness later from Virginia Power in Virginia. It did occur that the State public utility commission determined that the lowest cost power was not necessarily the determinative factor. And in fact, that they were getting uneasy about the amount of independent power being produced.

I do not want to get into too much detail because I am not an expert on that, but my understanding is that the State PUC, in fact, exercised its discretion and said you shall build it yourself. Even though these bids appear to be lower, we are uneasy about the fuel mix and the degree of your reliance upon independent power. We are not going to allow that to go forward strictly on a price basis.

The CHAIRMAN. If the Senator would further yield? I hate to cause all of these interruptions, but this is really a key point.

One other sort of self operating field leveler is that IPP's generally borrow on 15 years to 20 years because that is all that they can borrow money in the marketplace, whereas, utilities are 30 years. So that is kind of a self-correcting.

And utilities have the advantages over long-term borrowing. IPP's may be for leveraging to the extent that that is an advantage. I think our figures show it is not so much of an advantage as we thought.

And, indeed, the utilities could set up a subsidiary and sell back to themselves on a cost of service basis if it such a big advantage to have this leveraging. But it really, I think, is not. And that is what our study indicates.

But I thank you for bringing up that issue.

Senator WIRTH. I am going to continue to ask this until I am really satisfied there is an answer to the problem. I think it is real and I would appreciate, Linda, if you could have maybe your legal beagles or economists down there look at this.

Maybe there is a possibility of crafting some kind of language that we might put in the legislation before we get to the point where you have an unequal situation.

Anyway, if we anticipate that, I think it might be a wise thing to do.

Thank you very much, Mr. Chairman. I appreciate having so much time. Thank you. And I thank all the witnesses. Mr. Fleischman, again, thank you very much, sir.

The CHAIRMAN. I believe Senator Akaka was next.

Senator AKAKA. Thank you very much, Mr. Chairman.

This is really a great education for me to read up on PURPA and IPP and other moves here. And also to learn of the awesome responsibility that not only the Senate and the Congress have, but the Commission also has in protecting the public interest, the interest of investors, as well as consumers, all at the same time and try to balance all of that. It is awesome.

I hope together we can come up with some consensus as to how we can help all of these interests.

Also, you have that responsibility of looking at our country to bring about changes that can help these areas. And when I think of you favoring the repeal of the 1935 act, to try to modernize regulations, and also in 1978 to try to stimulate the alternate energy production with PURPA. Now, here we are trying to open new doors. It is a tough job.

What I wanted to particularly ask, to follow up on the line of questions regarding prohibitions against domestic utilities owning and operating facilities in Kuwait or any other foreign country.

Mr. Fleischman, is that a problem that you believe should be addressed? And if so, can you recommend language to address that issue?

Mr. FLEISCHMAN. Senator Akaka, with your permission, I am going to ask our Director of the Division of Investment Management to answer your question. She has been very much involved in this issue.

Senator AKAKA. Thank you.

Ms. SMYTHE. Thank you, Commissioner Fleischman.

Senator Akaka, the act right now does impose itself on the ability of American companies, especially public utility companies, the ones with the expertise in this area to own and operate power companies overseas.

As you may know, the staff of the Commission has been dealing for some time with the Hawaii electric system in trying to fashion a way to legally, lawfully, of course, allow this to happen. I cannot speak for the Commission because we have not yet been able to bring the matter to the Commission because the company has been wrestling with some decisions of its own.

The staff of the Commission has been committed to working as creatively as we can with the company. But as I am sure you and the other Senators appreciate, we must operate within the law and can go only so far. As in the whole area of EWG's, the act does interpose itself in a way that often requires very peculiar corporate structures to achieve fairly simple objectives.

The best I can tell you is, yes, the act is an impediment. The staff has been working as best it can to address that problem within the letter of the law. And we have not spoken to the Commission, so I am not speaking for the Commission now, but just for the staff of the division.

I would be glad to answer any more specific questions you might have.

Senator AKAKA. Now that you have made those remarks, let me ask, would this issue be resolved by the Johnston-Wallop or administration bill?

Ms. SMYTHE. There would be a substantially easier path for the companies to walk if the bills in any of their present formulations were passed. Yes.

Senator AKAKA. Thank you very much for your responses. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bumpers.

Senator BUMPERS. Mr. Chairman, I will be brief.

I think probably, Linda, this ought to go to you or Ms. Marlette. I obviously have a concern about a repetition of what we got into with the Grand Gulf plant.

Let me ask you this question on the bill. Would the State have any right to do a review of a competitively let contract before construction started on the project?

The Grand Gulf was constructed by a wholly owned subsidiary of what was then Middle South Utilities. And my question is, they entered into a contract with the subsidiaries of the holding company to take a certain percentage of the capacity of that plant.

Now in this case, let us just take an illustration. You are going to let a competitive contract for 1,000 megawatt coal-fired plant and you send out an invitation for bids. Let us assume that the bids come in, first of all, and they conclude that they have picked the most suitable bidder, if not the lowest bidder to provide this 1,000 megawatts of power.

Before they let that contract, does the State regulatory commission have any jurisdiction for a front-end prudence review on how this whole thing developed?

Ms. MARLETTE. Senator Bumpers, in your hypothetical, I am assuming you are talking about one of the operating subsidiaries.

Senator BUMPERS. That is right. I am assuming they are planning to, we will say if they have four companies, they are going to distribute 250 megawatts to each one of the subsidiaries and it is built outside the State of Arkansas in this case. Let us assume you are going to build this plant outside the State and the holding company is going to allocate, under contract, 250 megawatts of power to each one of its subsidiaries.

Ms. MARLETTE. And would *Pike County* apply there or would the *Mississippi* decision?

Senator BUMPERS. Yes.

Ms. MARLETTE. I think because, and I am very familiar with the Middle South case, I think because of the integrated nature of the holding company and because of the Supreme Court decision, that the Commission's approval of the wholesale contract, if the Commission had to allocate the cost of that power among those four subsidiaries, that the State would be bound by that.

Senator BUMPERS. The holding company, under normal circumstances, the holding company in this case before they allocate 250 megawatts of power to the State utilities, one of the subsidiaries, there would have to be a showing before the local regulatory commission that that power was needed, would they not?

Ms. MARLETTE. That is correct.

Senator BUMPERS. And if they found that the power was not needed, could they enjoin the local subsidiary from entering into a contract to take that 250 megawatts of power?

I am talking about under this bill. Anybody? Does anybody in the audience know the answer?

Ms. STUNTZ. I believe under the administration's bill, Senator, that could occur.

Senator BUMPERS. What could occur?

Ms. STUNTZ. The State's contract review could occur. Let me defer, if I might, to Kevin Kelly, the Director of the Office of Electricity Policy in DOE who is more familiar, I believe, with the factual situations surrounding Grand Gulf and Middle South that motivate your question.

Mr. KELLY. Senator Bumpers, under the administration's bill if Middle South, let us say, were to set up an EWG in Louisiana, and then that EWG were to sell back to the Middle South system, that would require the prior approval of every State commission, including Arkansas, for example, in the Middle South system if the EWG were to retain the exemptions from PUHCA that this act provides.

Senator BUMPERS. Is that a change in the law that exists right now?

Mr. KELLY. No, sir. It does not affect the ability of an operating company of the Middle South system to set up a unit in rate base in the traditional way. That aspect of the so-called Grand Gulf situation is neither helped nor hurt.

Our goal was to say that, by establishing a new category of entity called an EWG, that would not be a new avenue for creating

Grand Gulfs. Instead we would put in protections against that being an avenue for having new Grand Gulfs, by allowing State commissions to pre-approve contracts between exempt wholesale generators and the parent holding company as a condition for retaining their exemption.

Ms. Marlette. Senator, I think there is a distinction between the State's authority—the individual States who have retail rate jurisdiction over the individual operating companies, their authority to approve, for example, spin-offs or creation of facilities. I think clearly they have that kind of approval. What I thought you were addressing was more the wholesale cost allocation type situation.

Senator Bumpers. I am. The wholesale cost. I am talking about the capacity cost. Now, FERC is going to wind up, of course, setting the rate, and as I understand it, even under the Johnston bill we would have no authority to look beyond the rate FERC set. Is that not correct?

Ms. Marlette. That is correct.

Senator Bumpers. We could go back and look at the prudence of the contract in the first place, perhaps, but I think you are very limited when you do that. I mean, I think the cow is already out of the barn.

Ms. Marlette. Although, as you may be familiar, the next round of *Mississippi* is currently pending cert before the Supreme Court again as to what the outer bounds of the Pike County authority are, so there is another go-around.

Senator Bumpers. Ms. Stuntz, I want to ask you, you mentioned the administration bill. Does the Johnston bill operate the same way in this situation?

Ms. Stuntz. No, it does not. As I said, in the situation where a registered holding company is involved, I think Kevin explained we do not change current law.

What we do attempt to do is, by allowing these EWG's we do not want to create new additional opportunities for Grand Gulf situations. Once the allocation of cost is determined by FERC, we do not provide an opportunity for that to be second-guessed, if you will, by the State, and so to that extent we do not change current law.

However, what we have tried to do in our legislation is to say that in the beginning, if there is an EWG that is an affiliate of a registered holding company which intends to do an affiliated transaction, the States would have to determine in advance that that transaction is acceptable to them before that transaction could be allowed, or it would jeopardize the holding company's to own an EWG without SEC approval.

Senator Bumpers. Well, who under either bill is going to ride herd over the correctness and the priority of the competitive process to make sure that that is done correctly, completely aside from whether the holding company subsidiaries need the power or not and how the cost is going to be allocated?

Who is going to regulate—let us just assume the registered holding company says, we are going to build a plant. We want a coal-fired plant of 1,000 megawatts. Give us your bids. So they get five bids, and let us assume they say well, four of you are irresponsible bidders and we are not. We do not believe that four of you have adequate financing to fulfill your bid. We doubt you could even get a bond.

Now, we the holding company have bid on this, and so we are throwing your four bids out and we are going to build a plant. Who rides herd over that decision?

Ms. STUNTZ. I believe it is a combination of Federal and State regulators.

Senator BUMPERS. At what point do they do it?

Ms. STUNTZ. They have got to do it right up front. I think the competitive procurement process itself is done at the State level. They are the ones who have to—they have an opportunity up front to set the terms and conditions under which the utility will procure power, and they have exercised that authority in those instances where they have decided to go this route. We are still not talking about a majority of the States.

As Commissioner Fleischman can explain better than I can, if the holding company itself was going to fund, for example, this applicant, he would be regulating that. Any financial transactions would have to be approved by the SEC. FERC in turn, to the extent it was a wholesale power transaction, would have to guarantee the rate.

So there are actually three different regulatory players involved there, and I know it is confusing but I think, if I understood your basic question, which was who polices the competitive procurement process, that, I believe, is the States.

Senator BUMPERS. Well, let me just make this statement, Mr. Chairman—and I know we have other Senators and I have probably taken more than my allocated time, but my chief concern here is at what stage the State regulators have any authority over this, and if they do not have authority on the front end, we are going to wind up just exactly like we did before, with a totally nonconforming result of what we thought we were getting into.

Unless they have some authority—first of all, they certainly ought to have the authority to say that, for example in our case, that Arkansas Power & Light cannot contract for any part of this power without prior approval from the Public Service Commission. We do not want, nor does any other State want, unneeded power, and we do not want to have to pay for power that we have no need for.

I am anxious for the answer to whether or not the State can ride herd over that at that point, before any construction or anything else, any contracts are let, any construction begun. There is no problem with that, is there, under either bill?

Ms. STUNTZ. Certainly I could speak with respect to our bill.

Senator BUMPERS. Senator Johnston, you are the author. What do you say?

The CHAIRMAN. Well, we have a provision which we have not put in as part of the bill yet to clarify enhanced State authority, and I think we have got a panel this afternoon principally to deal with that. It is a very touchy decision.

Really, what you are asking for I think is a veto by the States of a multistate holding company purchase from an EWG.

Senator BUMPERS. Only as it affects the holding company within that State, though. I mean, only the subsidiary within that State.

The **Chairman**. Well, that would make it very difficult for them to operate as a system.

Senator **Bumpers**. But it may make it very difficult for the ratepayers if they do not have that authority.

The **Chairman**. Well, I understand that Middle South case and all of its implications.

Senator **Bumpers**. Well, you know, I cannot vote for anything that does not correct that. I mean, people in my State are still upset about that.

The **Chairman**. Well, I understand that. In New Orleans they want to correct that, too, but do we want to prevent—make it very difficult for multistate holding company to operate as a system? That is really the question, and I think we ought to further explore that. That is a very central question in this whole case. The draft that we have to clarify and enhance that authority does not grant an absolute veto to the PUC of an individual State in a multistate holding company situation.

Mr. **Fleischman**. Mr. Chairman, part of the Federal-State accommodation that the Congress enacted 55 years ago, without dealing with the authority of the State commissions, did make clear that, in a circumstance such as the one to which Senator Bumpers is addressing his question, where the holding company has to go out and finance, the SEC may not issue the order on the financing if a State commission advises the SEC that State laws applicable in a matter have not been complied with.

Senator **Bumpers**. Well, that is very interesting, commissioner, because that would give us the right—that gives us considerable weight, and we can pass some additional laws, perhaps. But let me carry the illustration just one step further.

Let us assume that we needed the 250 megawatts of power we are talking about and we have no objection to the registered holding company contracting for that power, but we also want—because our law says, for example, that Arkansas Power & Light will furnish power to the ratepayers at the lowest possible cost. That is what our law says, and so we need that.

Once we decided we needed the power we have a second question to answer, and that is, is this subsidiary going to get power at the lowest possible cost? That goes to the heart of what procedures have been used to let this contract.

In the case I mentioned a moment ago, let us assume the holding company says well, we have got five bids here and four of them are highly questionable. We are throwing those out. We are going to build it, even though our bid is $10 million higher than the next, or is $10 million higher than the low bidder, or $20 million, or whatever it is. At that point, it seems to me that the PUC ought to have the authority to regulate.

Our fearless Chairman says my time is up. Thank you, Mr. Chairman.

The **Chairman**. Thank you.

Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman. I just have one question, and I would like to ask each of the witnesses. It relates a little bit to some of the points that Senator Bumpers was making about competition and restrictions.

Do you think it makes sense to have any restrictions on where utilities could be independent power producers? Do you think it makes any sense to restrict them to be only within their area of jurisdiction, only outside their area of jurisdiction, or do you think it has any relevance at all?

Ms. **Stuntz**. Geographically, I do not believe there is a case for any such restrictions.

Ms. **Marlette**. I agree.

Mr. **Fleischman**. I have no difference on that, Senator Bradley. The effort being made to reduce cost and to reduce dependence on foreign sources would indicate that it should make no difference whether a utility is inside or outside its own service area.

Senator **Bradley**. Thank you very much, Mr. Chairman.

The **Chairman**. Could we ask our second round in writing? We have four more witnesses we have to finish by 1:00 p.m., or five more witnesses.

Senator **Shelby**. That is fine, Mr. Chairman. I was just going to get into wheeling, or transmission. I think that is important here, too, but I could do it in writing.

The **Chairman**. I think it is, and we can get into that with the next panel. This really has been an excellent panel, and I wish we could keep you here all day, but thank you very much.

We do, indeed, have a second panel, composed of Bill Berry, chairman of Dominion Resources in Richmond, Paul Elston, who is CEO of Long Lake Energy Corporation involved in IPP's; Scott Hempling, representing Environmental Action Foundation; Sherwood Smith, chairman and CEO of Carolina Power & Light from Raleigh, North Carolina; Don Jordan, chairman and CEO of Houston Lighting & Power Company. And if you all would come to the podium at this time.

If we could follow the same general format we had with the last panel and ask the witnesses to try to summarize in about 6 minutes, that will allow time for questioning.

And let us begin with Bill Berry.

STATEMENT OF WILLIAM W. BERRY, ON BEHALF OF THE PUHCA REFORM COORDINATING COUNCIL

Mr. **Berry**. Thank you, Mr. Chairman. I am here today on behalf of the PUHCA Reform Coordinating Council. The council is a group of six organizations representing about 350 companies—utilities, nonutility producers, industrial customers and fuel suppliers—who support amending PUHCA as a crucial step to expand competition in the supply of electric generation to utilities.

I will address this issue from the perspective, though, of a utility needing additional generating capacity, as most utilities will during this decade.

Virginia Power has had more experience in buying generation in competitive markets than any other utility. We needed to add about 5,000 megawatts of generating capacity in the 1990's, and Virginia Power has already made four competitive solicitations for 3,850 megawatts of capacity. We received total bids for more than 33,000 megawatts, with offers ranging from 7 to 10 times the amount we were seeking.

We evaluated these bids, considering both price and nonprice factors, to select projects that would provide the lowest cost reliable service over the lives of the contracts.

We now have contracts for about 3,000 megawatts of competitively bid capacity, and we are getting about the amount of completed capacity that we expected.

Some may say, or said, that none of the competitively built units would get built, but in the last 12 months alone about 900 megawatts of new, nonutility capacity has come into service, bringing the total nonutility capacity serving Virginia Power to 1,200 megawatts.

The performance of these operating units has been excellent, with availabilities of over 90 percent.

The units we bought competitively are essentially dispatchable, and the larger ones are under automatic generation control, just like Virginia Power's own units. Our ability to control our generating system for reliable and economic cooperation is as strong as ever.

Capacity we purchased is more economical than our own construction, and it is providing substantial savings to our customers.

If that were not so, we simply would not buy. In one solicitation, we rejected all of the bids because we could build cheaper ourselves.

Last year, Virginia Power completed 500 megawatts of new utility capacity, and we have another 1,000 megawatts of utility capacity under development. The competitive generation market expands our options. We are not required to buy. We are not required to build. We do whichever offers the better deal for our customers.

When Virginia Power proposes to build, we bear the burden of demonstrating to our regulators that building is the right choice in view of the offers we have received in the marketplace, so even when we build, competition helps assure the most economical capacity is developed.

You will hear claims that buying generation will weaken the utility's credit standing and increase its debt cost. Well, Standard & Poor's recently reaffirmed Virginia Power's credit rating after a thorough examination of our capacity buying practices.

Their report noted that there are risks in buying, but Standard & Poor's stated, "Management has demonstrated an ability to effectively manage the buying program to limit reliability risks." We believe an appropriate buying system actually reduces utility risk in acquiring needed generating capacity.

The issues of self-dealing and cross-subsidization have been handled effectively in Virginia. Dominion Resources, an exempt holding company, decided as a matter of policy that its nonutility power company would not seek to serve Virginia Power, and the Virginia Corporation Commission later prohibited affiliate power sales.

Dominion Resources is also subject to a State order that prohibits any services or other transactions between Virginia Power and a nonregulated affiliate without specific regulatory approval. We strongly support the wall between our regulated and nonregulated businesses and, in fact, no transactions occur.

These Virginia policies are not the only appropriate ways of avoiding unfair self-dealing and cross-subsidization, but they illustrate that State authority exists and are being exercised to prevent these abuses.

With the positive results we have had, you may ask why we need PUHCA reform. The answer is that we want reform because PUHCA reduces competition and increases cost, to the disadvantage of our customers.

To develop a nonutility plant under present law, you generally need to cogenerate, because being a cogenerator exempts you from PUHCA, but we have clearly seen that the natural steam uses are limited in number, and the best ones are quickly taken.

We have seen it gets increasingly difficult and costly for developers to find or to contrive steam use. We have seen how the steam imperative makes project siting more difficult, and how it virtually rules out nonutility development of gas-fired peakers and mine field coal units.

Cogeneration that is chosen as a ticket into the market needlessly increases the cost of electricity to our customers. The alternative of developing projects outside of PURPA requires convoluted business arrangements to avoid becoming a holding company.

These arrangements are also costly and difficult. Virginia Power lost the benefits of one economical project that won in our bidding because it failed to find a satisfactory way around PUHCA.

The two non-PURPA independent power projects being developed for Virginia illustrate the safeguards that exist quite apart from PUHCA. These projects were chosen in competitive bidding that is governed by State regulatory rules and operates under continuing regulatory scrutiny.

Their rates were examined by the FERC to assure that they did not result from market power or involve self-dealing. These projects required the direct approval of the Virginia Corporation Commission, and the Commission will separately approve or review the appropriateness of Virginia Power's decision to buy from these producers.

None of these protections will be reduced in any way by exempting independent power producers from PUHCA and opening the way to all competitors. Attempts to equate competition in power generation with the S&L debacle are simply ludicrous. PUHCA reform will provide significant benefits to Virginia Power's customers and to electricity customers throughout the Nation, and I urge you to support it.

The CHAIRMAN. Thank you very much, Mr. Berry.

Mr. Elston.

STATEMENT OF PAUL ELSTON, ON BEHALF OF THE NATIONAL INDEPENDENT ENERGY PRODUCERS

Mr. ELSTON. Thank you, Mr. Chairman, for the opportunity to testify today.

I am the CEO of a company that has built and operates six hydroelectric projects in upstate New York. We are also building a 300 megawatt gas-fired cogeneration facility on Long Island and two 340 megawatt gas-fired peaking facilities. These last two facilities are independent power plants which will be regulated under the Holding Company Act in the absence of reform.

I am also a spokesperson for the National Independent Energy Producers on PUHCA reform.

We support PUHCA reform and believe it is an essential part of a comprehensive energy bill designed to increase our national energy supplies and our energy efficiency. And we applaud your leadership on the issue.

Electric utilities are the largest consumers of energy in our country, consuming 36 percent of the total in 1990 and projected to consume 41 percent of the total in the year 2010. By comparison, the transportation sector used only 28 percent of the total energy consumed in 1990.

The Department of Energy predicts that the Nation will need 134 gigawatts of new capacity by the year 2000, which will require an investment of between $100 billion and $200 billion.

The efficiency of this investment will have a significant impact on our energy future. That is the primary issue before this committee today.

We believe the record of the 1980's shows that the economic and energy efficiency of the electricity system is best achieved through competition. PUHCA reform will improve competition, reduce costs, and provide incentives for good performance.

By allowing new producers, products, and sources of capital into the generation market, it will stimulate technological innovation and shift risks away from the ratepayer to the independents and their suppliers. By enhancing flexibility in plant siting, design, and operation, PUHCA reform will allow independents to more efficiently meet the needs of utility purchasers.

In addition to these benefits to our domestic electricity system, PUHCA reform will also free U.S. independents to sell their products abroad. The current PUHCA law as applied to independents is a classic example of a statute that through the passage of time, has turned on its head, the intent of the original Congressional sponsors.

PUHCA was designed to simplify utility corporate structure and to make it more accessible to regulation and accountable to its shareholders. It is now forcing companies like mine to turn our corporate organizations into pretzels where ownership is often divorced from control.

PUHCA was not enacted to regulate a company like Long Lake Energy Corporation, which does not control captive ratepayers and does not control transmission facilities, or possess other forms of market power.

PUHCA reform will relieve independents from this unnecessary and undesirable regulation, and allow us to compete both here and abroad.

Exempting independents from the Public Utility Holding Company Act can and should lead to stronger, more efficient regulation of wholesale generation by both FERC and the States. Intensive corporate regulation of registered holding companies and other franchise utilities would continue.

PUHCA reform will not require any utility to buy any power from any independent. It is voluntary. The utility executive will not buy from an independent unless it is a good deal for the utility and the ratepayer.

Most criticisms of PUHCA reform start with the assumption that utility executives and their regulators approve bad contracts and then blame PUHCA reform for these bad decisions.

PUHCA reform will simply increase and improve competition and provide more options to utilities and the regulators. It will not require them to buy.

The benefits of competitive power are now being recognized around the world. PUHCA reform is needed to free independents to develop and sell their products into foreign markets which are estimated to require 1 million megawatts of new capacity by the year 2010.

The rebuilding of electric facilities in Kuwait illustrates this problem. It would be a bitter irony, indeed, if U.S. independents were forced to sit on the sidelines while Japanese and German companies, unrestrained by PUHCA, gain the lion share of the contracts from a country rescued by American arms. Simply put, without PUHCA reform, the U.S. independents will be shut out of these markets.

As a final point, I would like to recommend that consumer protection provisions be added to title XV to ensure that we realize the full benefits of competition. We believe such provisions should clarify and strengthen the role of State regulators and FERC. No contract should be approved which is not the result of free and fair competition.

We must protect against self-dealing, cross subsidization, and unfair or discriminatory use of transmission facilities to determine the outcome of competition. In our written testimony, we offer detailed recommendations on such provisions.

Reform of PUHCA will lead to greater efficiency, save consumers billions of dollars over the next decade and make our industry more competitive internationally.

It will also allow independents to export their expertise to foreign markets. It will give regulators better market information to regulate with and give utilities more options to meet their supply needs.

We look forward to working with members of the Congress and achieving a more efficient and secure energy future for the United States.

[The prepared statement of Mr. Elston follows:]

National Independent Energy Producers

Telephone: (202) 783-2244
Facsimile: (202) 783-6506

WRITTEN STATEMENT OF THE
NATIONAL INDEPENDENT ENERGY PRODUCERS
SUBMITTED FOR THE RECORD

before the

UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES

Washington, DC

HEARINGS ON:
TITLE XV OF S.341, THE NATIONAL ENERGY SECURITY ACT OF 1991

March 14, 1991

I. INTRODUCTION

The National Independent Energy Producers (NIEP) is pleased to submit the following statement for the record on Title XV, "Public Utility Holding Company Act Reform" ot the "National Energy Security Act of 1991."

NIEP is an association of companies that generate electricity for sale to utilities and develop cogeneration projects for a variety of users. NIEP membership is comprised of both publicly traded and privately held corporations which represent the entire spectrum of fossil fuel-fired and renewable technologies, including hydro, pumped storage, biomass, geothermal, wind, wood and waste-to-energy plants, as well as oil, gas and coal-fired cogeneration and independent generation facilities. We do not build ratebased powerplants. Our plants use the latest and cleanest technologies.

NIEP is committed to increasing competition in electric power generation markets to improve the efficiency of those markets. Independent generation has grown out of the entrepreneurial and competitive climate fostered by the Public Utility Regulatory Policies Act of 1978 (PURPA). Since this 1978 legislation made the competitive power industry a possibility, independent electric producers have grown to more than 32,000 megawatts of capacity -- equivalent to over 30 large nuclear power plants. In addition, this new industry has supplied about 20 percent of all new electric capacity since 1978 and has brought on-line 50 percent of new capacity since 1989.

Independent generators in competitive power markets play a vital role in meeting the demand for new electric generating capacity. NIEP believes that competition in electric generation markets is the best system for achieving energy, economic and environmental efficiencies in the production of electricity. Reaching these goals in the electricity sector is essential for the nation's competitiveness in global markets.

NIEP advocates amendments to the Public Utility Holding Company Act of 1935 (PUHCA) to remove institutional and regulatory barriers to market entry by independent generators of electricity (called "exempt wholesale generators -- EWGs" in the legislation). Currently, PUHCA blocks entry by independent generators which lack market power, when it was intended to do something else -- end the monopolistic abuses of ratepayers and shareholders associated with dispersed utility holding companies in the 1920s and '30s. Changes in PUHCA are essential to promote competition in wholesale electric generation markets for the benefit of the nation's consumers because they will give utilities additional supply options from which to choose in meeting ratepayer needs.

However, without the means to protect these emerging competitive bulk power markets from anti-competitive behavior by entities possessing market power, the goal of increased competition could quickly be subverted. Therefore, to enhance competition in power generation markets and maintain vital consumer protections, we urge the Senate to include in S. 341 additional protections to prevent the abuse of market power, including cross-subsidy, self-dealing, and abuse of transmission control.

II. WHY PUHCA REFORM IS NECESSARY

A. Competition in Power Markets Promotes Energy and Economic Efficiency

The need to amend the Public Utility Holding Company Act derives from the growing requirement for new electric generating capacity to maintain economic growth and our quality of life. The Department of Energy predicts that the nation will require 134 gigawatts of new capacity by the year 2000, an increase of 20 percent from the current generating capacity.[1] This translates into an investment in new generating capacity of an estimated $100 - 200 billion.

The question facing policy makers is not whether that investment will be made, but rather how efficiently. The cost per kilowatt-hour and the total dollars spent by this nation on electricity affect not only economic growth at home, but our competitiveness abroad. Competition in power markets is the structure in which the most energy and economically efficient generating capacity investment decisions will be made.

Energy Efficiency

The crisis in the Middle East has once again focused Washington's attention on the need to improve energy efficiency to reduce our dependence on foreign oil and protect national security. The need to increase the efficiency by which this nation consumes electricity will likely remain a critical policy issue in the 1990's, given the fundamental concerns regarding national security, our economic health and the state of the environment.

The United States consumes far more energy per capita than any other industrialized nation, except Canada. We also use more energy per unit of gross domestic product (GDP) than any other industrialized nation, except Canada, an indictment of the relative energy efficiency of our economy.

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[1] Department of Energy, *Annual Outlook for US Electric Power 1990*, Energy Information Administration, June 1990.

Our consumption of energy not only affects our global competitiveness, but also our overall quality of life. The Department of Energy, in its National Energy Strategy, recently noted, "Greater energy efficiency can reduce energy costs to consumers, enhance environmental quality, maintain and enhance our standard of living, increase our freedom and energy security, and promote a strong economy."[2]

In particular, the importance of efficiency in the electricity sector grows. Currently, at 36 percent, the production of electricity is the single largest consumer of primary energy in our economy. (Transportation is second at 28 percent). Furthermore, industrial, commercial and residential consumers have been shifting their energy use to electricity. Since 1970, the percent of primary energy consumed (energy as an input for all end uses) in the United States going towards the production of electricity has grown from 24 percent to 36 percent in 1990.[3]

Clearly, by any measure, increasing the efficiency of the electricity sector is very important for achieving the nation's overall energy goals. We believe that, in competition, the search for a competitive edge will force suppliers to find ways to be more efficient -- to more efficiently convert fuel to electricity and to develop other innovative technologies. Experience over the last decade shows that the market opportunities created by PURPA and competitive procurement has stimulated innovation and efficiency in generation technologies.

Economic Efficiency

Over the next ten years, achieving cost savings and economic efficiency in generation markets will be important for economic growth. The Department of Energy estimates that the nation consumed $160 billion worth of electricity in 1989. In addition, as noted earlier, we will need to invest some $100 - $200 billion of capital in new electric generating capacity by the year 2000.[4] Competition will reduce not only the capital costs of new capacity, but will promote cost savings in fuel use and operation in the production of electricity.

The record of reliable and efficient independent power demonstrates that competition reduces costs. Generation is the competitive part of the electricity system. A recent report by the staff of the Federal Energy Regulatory Commission (FERC) concluded that,

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[2] Department of Energy, *National Energy Strategy*, First Edition, 1991/1992, February 1991, page 6.

[3] *NES*, pg.6.

[4] *NES*, pg. 30.

"The generation sector no longer exhibits the attributes of a natural monopoly, whereby efficiency would require a single seller; therefore, competition can be used to discipline the investment and pricing decisions of the industry."[5]

The nation's consumers have much to gain from increased participation of independent generators in competitive electric power markets. First, a decade of experience with the Qualifying Facilities (QF) program under PURPA has shown that non-utility generation could compete effectively on a cost basis with utility facilities to provide efficient and reliable generation for the nation.

The success of the QF program, and non-utility generation in general, in contributing new electric generating capacity and in bringing competition to power markets has far exceeded anyone's expectations. During the past decade, QFs and non-QF Independent Power Plants (IPPs) have grown to over 32,000 megawatts (MW) of electric generating capacity, or about 5 percent of the nation's capacity.

Also, competitive processes to supply future capacity needs are taking hold throughout the nation. Since 1984, utilities and/or public utility commissions in 27 states have adopted or are developing competitive bidding to procure generation capacity. As of February 1991, 62 requests for proposals have been issued, resulting in developers bidding nearly 150,000 MW of capacity. On average, ten MW have been bid for each one requested. In addition, independents have offered utilities seeking capacity other competitive options outside formal bidding. Utilities and independents use competitive negotiation and arms-length negotiation to solicit and propose projects outside bidding or where bidding does not yet exist. Developers have offered diverse fuels and technologies in their efforts to gain a competitive advantage. **(See Attachment Charts 1 and 2).**

As we look at the data provided by examining competitive procurement systems, there is no question that the process has led to lower costs for electricity. By February of 1991, as a result of competitive bid solicitations, utilities awarded bids to over 11,000 megawatts of capacity. In each of these winning bids, the utility's decision to buy capacity rather than build themselves resulted from their own evaluation that wholesale power purchases would be cheaper. In the relatively short time since competitive bidding began, over 1750 megawatts procured through bidding have completed development and have begun delivering power.[6]

Cost savings have also been achieved through arms-length negotiated contracts. In Texas, 3,254 MW of power have been purchased under contracts negotiated in a competitive environment since 1984. All of these contracts were below avoided cost at the time of signing. The reliability of the projects represented by those contracts meets or exceeds that of the most successful bidding program in that all of the negotiated projects came on line. In addition, a recent study by the Massachusetts Electric Company comparing bidding through RFPs and

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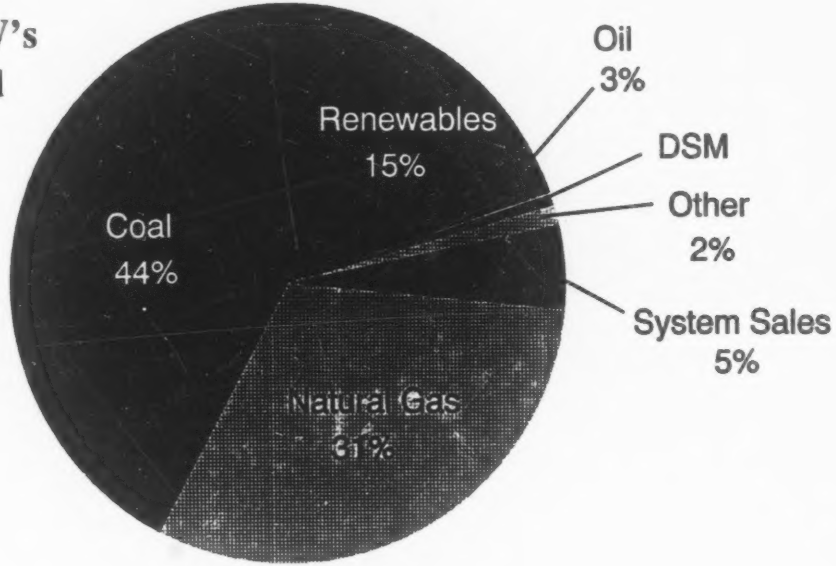
[5] Federal Energy Regulatory Commission, *The Transmission Task Force's Report to the Commission, Electricity Transmission: Reality, Theory and Policy Alternatives*, Washington, DC, October 1989, p.165.

[6] *Robertson's Current Competition*, Vol. 2, No.4, pages 13,20.

Independents Offer Diverse Fuel Mix

% of MW's
Offered

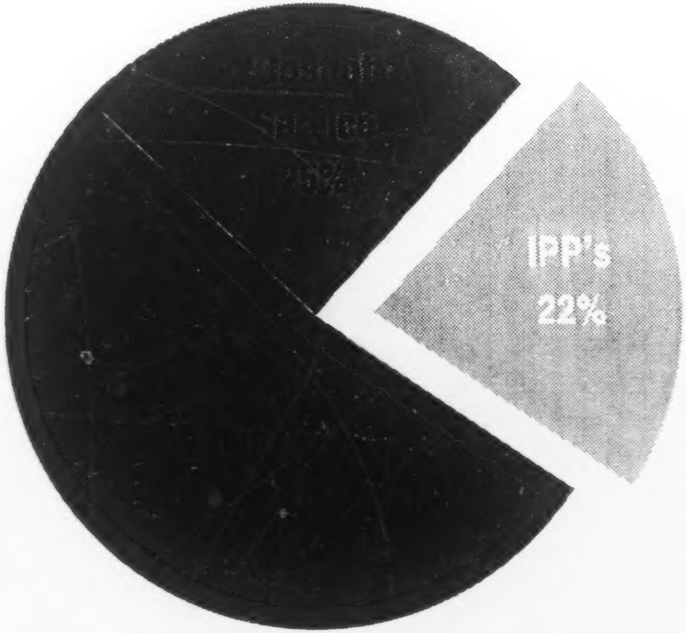


And a Quality Product

Attachment Chart 1

22% of MW Have Been Awarded to IPP's

Virginia 1987 - 1989



Source: NIEP

Attachment Chart 2

negotiated contracts concluded that there were "no significant differences between prices signed under negotiation and those winning RFPs."[7]

B. Competition Provides Other Benefits to Ratepayers

Gains from Competition

Competition does more than just reduce cost. Wholesale generators in competitive markets are emerging as vital supply options to meet the need for new electric generating capacity in the 90's. Among the major benefits to electricity consumers and our national economy from competition are:

- Removing barriers to competition by allowing new products and producers into markets;
- Encouraging least-cost pricing through increased supply options for consumers which will reduce cost and increase our national competitiveness. Reliance on market forces, not regulation, to determine prices will optimize the efficiency of the system;
- Continued shifting of construction and operating risks from ratepayers to wholesale generators in a manner that promotes efficiency and penalizes incompetence; and,
- Increasing the incentives for technological innovation and market responsiveness.

Since PURPA, independents have demonstrated numerous benefits from competition. As the number of independents in the wholesale generation market has grown, competition among them has also increased, forcing them to develop better technology and use creative contractual and financing arrangements in an effort to provide a stronger, more efficient and less costly facility.

Competition Promotes Technological Innovation

Competition has stimulated technological development and innovation. There have been several energy generation and environmental control advances produced by independents since the passage of PURPA, and, as research continues in this area, there is little doubt that new technology will develop in the future.

Technological advances by independents include:

- Clean coal technologies such as circulating fluidized bed combustion to burn coal cleanly and burn low grade waste fuels, award winning coal gasification designs, and the dry limestone injection process for reducing the SO_2 emissions from burning high-sulfur coal.

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[7] Massachusetts Electric Company, *Alternative Energy Negotiation-Bidding Experience*, 1990 Report, pg.3.

- Dramatically more efficient combined cycle systems and gas peaking units which add a heat recovery system and a steam turbine for generating additional electricity.
- Advances in waste-to-energy technologies to burn wastes, such as municipal solid waste, tires, rice-hulls, and wood wastes.
- Cost savings through innovative approaches to expediting and streamlining development of hydro pumped storage and conventional hydro. Also, independents have demonstrated success in restoring and creating small hydroelectric projects.
- Leadership in developing commercial applications of geothermal, solar and wind power technology.

Developers have found ways to reduce their fuel risks through innovative procurement practices. Finally, independent facilities have achieved cost reductions relative to utility standards through lower construction costs and innovative construction contracting and performance guarantees.

Reliability of Independent Generators

Some utilities have disputed the gains from competition in power markets. They claim that without the utility obligation to serve, the proliferation of independent generation threatens the reliability of the nation's electric system. In the last decade, independents have proven their ability to both construct and operate power plants reliably. By all accounts, the operational record of non-utility generators is excellent, both under normal conditions and in emergency situations.

Selling power under a contract price to utilities creates strong incentives for reliable operation. Wholesale generators who are paid only for power actually delivered have a strong financial interest in the reliability of their facilities, stronger in many cases than utilities who can pass the costs of their mistakes onto ratepayers if their facilities do not operate properly.

A recent survey of 172 projects selected through competitive bidding since 1984 shows that the vast majority of projects (85 percent) are in development, under construction or on-line. **(See Attachment Chart 3)**. Less than 15 percent of those projects have been canceled, most of them very early in the process, and with little or no impact on utilities' supply plans.[8] In addition, utilities can and do factor failure rates for projects selected through competitive bidding into their resource plans.

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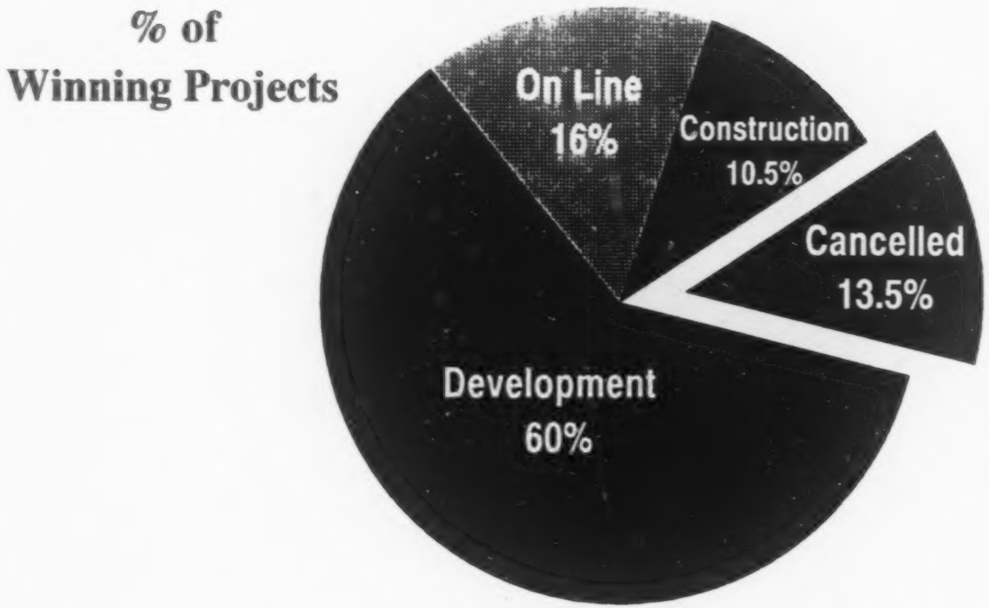
[8] *Robertson's Current Competition*, Vol. 2, No.4, February 1991, pages 2, 13.

Independents Are Reliable--
Only 13.5% Cancelled



Source: Robertson's Current Competition

Attachment Chart 3

Non-utility generators have strong records in operating their facilities reliably. For example, the Gulf Coast Cogeneration Association, in a survey of 3126 megawatts of cogeneration, reported an availability factor of 96.4 percent and a capacity factor of 84 percent for those projects.[9] Before its commission in 1988, Pacific Gas & Electric stated that the 1621 megawatts of non-utility generation in its service territory operated at a 94.8 percent availability factor.[10]

Non-utility generators also have provided much needed capacity to utilities during emergencies. In the 1989 California earthquake, cogenerators and other independent power producers stayed on line and helped PG&E to quickly restore service to consumers in the Bay Area. During the December 1989 deep freeze in Texas, cogenerators in the Houston area provided the utility with power in excess of firm contract commitments.

The nature of the project finance process provides a powerful discipline to insure reliability. For example, each project generally goes through three independent engineering evaluations: the developer, the construction-lender, and the suppliers of long-term financing. All have experts who intensively review every aspect of the design and construction plan of the project because they only get paid if the facility operates as specified.

Nevertheless, some utilities argue that you cannot count on independent energy projects because independents, unlike vertically integrated utilities (which control generation, transmission and distribution), do not have an "obligation to serve." But, as William Berry, Chairman of Virginia Power, noted in a recent speech, "the independent capacity already in service has had excellent reliability, with availabilities in excess of 90 percent. The capacity that we have bought competitively is essentially dispatchable and the larger units are under automatic generation control just like our own units. Our ability to control our generating system is as strong as ever." [11]

Although independents may not have a statutory obligation to serve, they clearly have the incentive and a contractual obligation to serve, both in their power sales agreement with the utility and in multiple agreements with lenders. Independents are subject to obligations to deliver power according to specific operating standards. They suffer severe financial penalties if they fail to satisfy these commitments. They also rely on the same performance guarantees from equipment suppliers, such as General Electric and Westinghouse, that utilities rely on in building their plants. In the rare event that an independent project fails, performance obligations flow to the mortgagor whose only recourse to recover his investment is to operate the facility and deliver power in accordance with the power sales agreement.

For these reasons, it should be no surprise that the record shows that the market-based incentives of contract generation have insured that independents are developing least-cost reliable power on schedule. Independents have also contributed to reliability by pioneering efficient combined-cycled cogeneration plants with fuel-switching capability and by building smaller plants which can be located closer to load centers, reducing the risk of major supply interruption when a large central station goes down.

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[9] Gulf Coast Cogeneration Association, *Survey of Cogeneration in Texas*, 1987.

[10] Jan Hamrin, "Non-Utility Power and the Reliability Issue," *The Electricity Journal*, 17, June 1989.

[11] Remarks of William Berry, Chairman of Virginia Power, to the Congressional Staff Briefings on PUHCA Reform, Washington, DC, February 20, 1991.

The contracts which independents sign with utility buyers contain provisions to assure a facility's availability and performance. In addition, utilities, as purchasers of non-utility power, largely dictate the security provisions required of an IPP in a power purchase agreement. If the security provisions of an IPP contract are unacceptable, the utility can simply refuse to purchase the power.

Financing of Independent Power

In addition, some skeptics argue that the only cost advantage independents have is the unfair use of higher leveraging and use of the utilities' credit to shift risk to the utility. Utilities traditionally have maintained a 40 percent common equity investment, the rest being preferred stock or debt. Independents, generally, use more leveraging. Financial theory tells us that debt is more secure than equity and demands a lower return than equity. Additionally, interest on debt is tax-deductible. Therefore, it is argued that independents enjoy a lower overall cost of capital due to their financial structure.

In fact, the capital structure of independents does not offer an artificial cost advantage. Independents must raise equity capital before construction or commercial operation. Higher levels of debt may make a specific project cheaper than a comparable utility plant since debt is cheaper than equity. However, a November 1989 study by the Chief Economist for the Senate Committee on Energy and Natural Resources, suggests that, on a generic basis, it is a "wash." The study notes the advantage of using more debt may be offset for at least two reasons: first, investors in debt and equity require higher returns from IPPs; and, second, the term of the debt is shorter for IPPs than utilities -- typically, IPPs borrow for 15 - 20 years, while utilities generally borrow for up to 30 years.

Moreover, the financial structure of an IPP is dependent on the intrinsic risk profile of the project as determined by the capital markets. By contrast, the amount of leveraging by utilities is determined by regulators, not by the market. Capital markets are more likely to be able to allocate the risk of a project among debt and equity to minimize the cost of capital, leading to savings for the ratepayer.

Additionally, the reliance on debt does not lead to unstable financial structure. The discipline of the financing process itself increases the financial accountability of projects. Banks require developers to clearly identify the sources of risk inherent in the project and attempt to manage them by assigning them to parties best able to bear those risks. In addition, projects undergo intensive review by the lenders' own experts to ensure that projects will perform well enough to cover their loans.

Furthermore, project financing is asset-based. Project developers pledge the asset and part or all of the project's revenues to lenders. Analogies to leveraged buy-outs, the S&L crisis, and the financial scandals of the 1920's are unfounded and irrelevant. Project financing is based upon the value of specific, tangible assets (the powerplant), while the other situations staked corporate balance sheets on abused government guarantees or the value of speculative or sham assets.

Finally, utilities can, and do, consider the financial reliability and stability of developers in choosing to purchase power from independents and take measures to safeguard against financial failure. If, for some reason, those safeguards ultimately do not work, and a developer goes bankrupt, another party may step in, buy the project and continue to supply electricity, since they will only make money by meeting the obligations of the power sales agreement. In addition, many contracts specify that in the event of a bankruptcy, the utility may take over and continue to run the project. All of this helps to ensure that the projects can continue to produce power economically over the life of the contract without interruption for consumers.

Some carry the financial unreliability argument further to say that the cost of capital for EWGs is also lower because the risk is shifted to the purchasing utility. Thus, the utility cost of capital rises as it buys more power from independents. However, the opposite is usually the case. The contract terms, including performance criteria, shift risk away from ratepayers and utilities to IPPs.

Furthermore, utilities regularly purchase power on a short or long term basis from other utilities with no adverse affect on their cost of capital. To argue otherwise would assume that utility executives will voluntarily make decisions which are bad for ratepayers and shareholders. All purchases from EWGs will be voluntary, and the terms and conditions of the contracts will be determined by the utility.

Utilities are able to manage the risks in their power purchase programs to eliminate any potential impact on credit worthiness. William Berry, Chairman of Virginia Power, the utility with the most experience with competitive bidding, has stated, "The issue is not whether a utility buys, but how it buys.... Only two months ago, Standard and Poors [the rating agency] reaffirmed Virginia Power's credit ratings. The report noted that there are risks in buying, but it stated -- quote -- management has demonstrated an ability to effectively manage the buying program to limit reliability risk."[12] Finally, buying power from independent generators and QFs displaces the need for utilities to undertake capital intensive and risky construction programs.

C. PUHCA is a Barrier to Increased Competition in Power Markets

Competition in generation markets cannot fully develop amid the complex regulatory schemes that currently restrict investment decisions and operation. The benefits of competition can only be fully realized by the removal of institutional barriers, principally those under the Public Utility Holding Company Act. PUHCA, as currently structured, impedes the development of independent generation facilities and competitive power markets by effectively barring market entry by new suppliers.

Passed in 1935, the Act, along with its sister legislation, the Federal Power Act (FPA), was intended to protect investors and consumers from the abuse of market power by utility holding companies so prevalent at the time. The protections against the abuse of market power embodied in PUHCA are still relevant today. However, the drafters of the Act could not have anticipated the changes that have occurred in the electric utility industry in the 56 years since enactment.

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[12] Remarks of William Berry, Chairman of Virginia Power, to the Congressional Staff Briefings on PUHCA Reform, Washington, DC, February 20, 1991.

PUHCA reform will only exempt IPPs from corporate regulation under the Act. Because IPPs do not control a franchise base or have captive ratepayers, regulation of IPPs under PUHCA to control market power abuses is inappropriate. Most independent power facilities are organized as separate corporate entities because today's financial markets require them to be project financed. They therefore must be developed into a holding company structure which subjects them to regulation under PUHCA.

The "penalties" for becoming subject to regulation under PUHCA include:

- PUHCA limits investments to businesses directly related to power generation. In addition, investments are confined to a geographic area, either one state or adjoining states;

- PUHCA requires the Securities and Exchange Commission (SEC) to pre-approve most investments, securities issuances and many contracts entered into by a regulated entity. PUHCA also controls the structure of company boards; and,

- PUHCA regulation of IPPs would classify them as an "electric utility" and force them to divest themselves of wholly owned QFs.

Clearly, development under PUHCA regulation is impractical for most independent generators. Therefore, independent generators are forced to follow a limited number of PUHCA exemption strategies. They may, for example, devise "Rube Goldbergian" corporate structures which divorce ownership from control and require elaborate legal maneuvering, which ultimately raises project costs. In addition, while these tactics may work for one project, PUHCA places increasingly difficult ownership and geographic restrictions on IPPs. Developers can choose to try to shoehorn projects into definition as a QF (QFs are exempted from regulation under PUHCA), which may force them to make uneconomic or inefficient siting, sizing and operational decisions for their facilities.

Finally, the lack of good exemption strategies discourages developers from entering and competing in the generation business. Some experienced companies simply will not take the risk of building IPPs without amendments to PUHCA. The restrictions placed on IPP development will not make the investment worthwhile for many independents. Clearly, PUHCA limits competition and will deny ratepayers the benefits of a more efficient industry.

IPPs are Good for Competition

IPPs are important for competition for a number of reasons. First, QFs will not be able to meet all new supply needs. To be eligible under PURPA, QFs must either "cogenerate" steam and electricity or use a renewable technology. The availability of "steam hosts" for cogeneration will not necessarily correspond to areas which need electricity, and, while there certainly is untapped renewable potential, the availability of renewables will not necessarily correspond to areas which need electricity. By contrast, IPPs can locate near load centers, fuel supplies or transmission interconnections. IPPs can also be sized to meet the needs of the purchasing utilities. On the other hand, to meet PURPA's requirements, QFs are restricted by the size of their steam loads.

IPPs can also be more responsive to utilities' demands for plants which are "dispatchable." A dispatchable contract permits a utility to schedule operation of non-utility generators to meet a utility's demands. Cogenerators, to maintain their QF status, operate according to the needs of their steam host and, many times, must produce electricity around the clock. Currently, many utilities seek to buy power from plants they can dispatch according to their "peaking" needs. Peaking plants operate only during spikes in the demand for electricity and usually operate no more than a few hours a day or a month. These plants must generally be available around the clock and start up quickly.

In addition, PURPA's siting, size and technology requirements can impose economic penalties on plants. IPPs who are not tied to a particular steam host or the remote location of some renewable sites can offer more flexible siting and sizing of plants, resulting in cost savings to the ratepayer. In addition, more suppliers can enter the market, not just companies with access to steam hosts.

IPPs can create new and viable options for utilities and states. PUHCA reform will permit new suppliers to enter the market and increase the choices utilities and states have to meet growing electricity demand. Increased competition gives regulators a benchmark for assessing the performance of their utilities versus other real options.

Modification of PUHCA, therefore, is needed to assure that wholesale generation facilities, in addition to QFs and ratebased plants, will be able to compete to meet the demand for electric generating capacity. In addition, changes which exempt independent generators which lack market power from PUHCA will allow developers to make truly economic and optimal choices in corporate structure, siting, size and technology.

IPPs Should be Free to Compete Abroad

Finally, PUHCA reform should free US companies to develop IPPs abroad and export US expertise in power plant construction and operation. There is a growing market for power projects overseas, in Europe, Asia, Latin America and the Middle East. Estimates of new demand for electricity range as high as 1,000,000 MW worldwide by 2010. In addition, new markets are opening up, such as the rebuilding of Kuwait. Much of the capacity may be built by private power developers, primarily US, Japanese and European companies.

However, as currently structured, PUHCA limits or hinders development abroad by US companies. PUHCA's geographic restrictions prevent both registered and exempt utility holding companies from making substantial investments in generating facilities outside the US. Non-utility generators who own generation abroad could not only become subject to PUHCA, but might also lose their ability to own 100 percent of a QF by virtue of being classified as utility holding companies.

Moreover, PUHCA has no effect on non-US companies who develop generation facilities. More than sixty Japanese and European companies are constructing, operating and maintaining power plants overseas, while US companies are restrained by PUHCA from competing in those markets. On the other hand, foreign companies can own generating facilities in the US without being regulated under PUHCA by using PURPA exemptions.

PUHCA Reform is Not Deregulation

To understand the impact of amending PUHCA, one must examine how PUHCA fits in the current utility regulatory structure. Utilities and IPPs are subject to a complex series of regulations at the state and federal levels. State and local governments control siting and need determination for new power plants. The Federal Energy Regulatory Commission (FERC) under the FPA, governs utility wholesale rates. The states control retail rates (i.e., cost to the ultimate consumer). The Securities Acts require companies to report financial transactions. PUHCA governs corporate structure for utilities and non-QF IPPs.

By advocating PUHCA reform, we are not calling for "deregulation" of generation, but the creation of regulatory structures which serve the needs of competitive generation markets. Changes to PUHCA would not alter provisions under the Act governing corporate activities by utilities (both exempt and registered utility holding companies) with a franchise base, other than permit them to invest in EWGs. Current regulatory scrutiny of corporate structure of utilities would also continue at the state level, under FPA, and the Securities Act.

Similarly, amendments to PUHCA would leave intact the current structure of electricity rate regulation. Wholesale rates for electricity sold by utilities and IPPs would continue to be approved by FERC under the Federal Power Act. Rates for QFs would continue to be capped at state-approved avoided cost. Although they do not regulate wholesale power rates, states would continue to supervise those markets through their authority to:

- control the design of bidding programs;
- approve power purchase agreements;
- require least-cost planning;
- approve siting; and,
- to the extent they are able under current law, conduct reviews of the prudence of utility power purchases in the context of retail rate regulation.

Under PUHCA reform, only IPPs would be freed from: 1) the need for SEC approval of investments and other financial transactions; and, 2) the limitations and geographic restrictions on investments prescribed by PUHCA.

III. PUHCA REFORM MUST NOT ALLOW ABUSE OF MARKET POWER TO THWART COMPETITION IN BULK POWER MARKETS

NIEP applauds the efforts that Senators Johnston and Wallop have made to promote competition in electric power markets by proposing amendments to PUHCA in Title XV of S.341, the "National Energy Security Act of 1991." At the same time, NIEP believes that the legislation can be strengthened with respect to the market power issues raised by utility ownership of exempt wholesale generators (EWGs -- as defined in the legislation).

To achieve the benefits of fully competitive power markets, PUHCA reform must protect against the abuse of market power and promote free and fair competition. Without the means to protect emerging competitive bulk power markets from anti-competitive behavior by entities possessing significant market power, the goal of increased competition could quickly be subverted. In addition, whether they contract through a formal bidding program or through arms-length negotiations, wholesale generators should demonstrate that they are the most appropriate supply option available.

Market Power

Market power is the ability of a single buyer or seller, or group of buyers or sellers, to influence through anti-competitive activity the price of a product or service in which it is trading. Electric utilities, because of their franchise monopoly, control of transmission facilities, or single buyer status have the ability to influence the behavior of generation markets. Utilities could potentially use their market power to give unfair advantage to utility-affiliated wholesale generators or to their own construction programs which compete with EWGs. PUHCA reform, by increasing competition from additional non-utility generators and by making it easier for utilities to invest in wholesale affiliates, may increase incentives for anti-competitive behavior. This may increase the need for vigilance by state and federal regulators to ensure compliance with existing laws prohibiting such behavior.

Potential anti-competitive activities which could arise from the exercise of market power in generation markets include:

1) **Self-dealing**: Self-dealing occurs when a utility pays an above market price for power or gives other advantages to a wholesale generation affiliate or to a proposed cost-of-service facility. Self-dealing can happen if:

    - utilities offer higher prices or more favorable contract terms for power to their affiliate;

    - the utility-affiliate has access to inside information regarding the terms and conditions of its parent's power supply solicitation; or,

    - utilities adopt procurement evaluation criteria to favor affiliates or their own cost-of-service construction programs.

2) **Cross-subsidies**: Cross-subsidy occurs when ratepayers' capital is used to reduce the cost of constructing or operating the affiliate, while profits earned by the utility

affiliate accrue to the shareholders and are not passed back through to benefit the ratepayer. In addition, competition is harmed if the affiliate gains a cost advantage from subsidized costs.

Cross-subsidy occurs if:

- utilities pass the construction, operation, siting, insurance or other costs associated with affiliates onto regulated activities to shift the risk associated with investing in affiliates from shareholders to their ratepayers;
- utilities provide engineering, legal and other expert assistance that was funded by ratepayers to unregulated affiliates.

3) **Abuse of control over essential transmission facilities:** The 1989 report by the FERC Transmission Task Force concluded that, "The current market power of transmission incumbents is so pervasive that independent power producers are unlikely to be willing to take substantial financial risks in the absence of assured access to the grid at reasonable prices." Utilities who control access to those transmission lines exercise market power if:

- utilities make transmission access available to affiliates while denying access to competitors;
- utilities deny transmission access to favor competing proposed rate-based plants;
- utilities refuse to give information about transmission capacity or availability to the public; and,
- utilities impose discriminatory prices, terms or conditions on transmission service for non-affiliated entities that make projects unfeasible or uneconomic.

Congress needs to address market power issues in the context of PUHCA reform and identify the appropriate mechanisms to include in the legislation to ensure that the benefits of true competition will be realized.

IV. ELEMENTS OF PUHCA LEGISLATION NECESSARY TO ACHIEVE FREE AND FAIR COMPETITION IN BULK POWER MARKETS

By exempting wholesale generators from regulation under PUHCA, Title XV of S.341 will create the opportunity for competition in power markets to flourish. However, to promote free and fair competition, and protect the consumers, we believe that Title XV would be more effective by strengthening existing regulatory authorities to protect against potential anti-competitive and anti-consumer abuses.

A. Title XV of S.341 Contains Provisions To Promote Competition

We strongly support the elements in Title XV designed to free wholesale generators who wish to compete in power markets from PUHCA regulation. Those elements include:

- creating a class of exempt wholesale generators (EWGs), freed from regulation under PUHCA. This would permit independents, and subsidiaries of utilities and utility holding companies, to develop EWGs to compete aggressively for the right to supply new capacity when utilities decide they need capacity. This will offer utilities additional, efficient generation options.
- permitting owners of qualifying facilities to own EWGs without jeopardizing their QF ownership;
- permitting exempt utility holding companies to own EWGs without jeopardizing their current exemption;
- permitting registered utility holding companies to invest in EWGs without triggering the "integration" requirements of PUHCA (all other regulatory requirements would remain intact); and,
- requiring regulatory approval to convert a rate-based facility to EWG status.

B. Title XV Can Be Strengthened to Ensure Free and Fair Competition

While Title XV is a positive step towards creating competitive opportunities, NIEP believes that additional consumer protections are warranted. The current regulatory structure governing wholesale markets is somewhat undefined. FERC has gaps in its authority and the role of states is unclear. An effective regulatory system to protect the consumer and ensure free and fair competition must have clear authorities, sensible rules and strong enforcement mechanisms.

By free and fair competition we mean any competitive process (whether formal competitive bidding, arms-length negotiation or other competitive process), consistent with resource or least-cost planning goals, in which there is no abuse of market power by the EWG, its affiliates, or by the purchasing utility, including no improper self-dealing between the EWG and the purchasing utility or utilities, no cross-subsidization of the EWG with ratepayer assets by an affiliated utility or utilities, no improper reciprocal dealing between an EWG's affiliated utility and other utilities, and no unfair or discriminatory use of control of transmission facilities by the EWG or any affiliated utility.

Therefore, NIEP proposes that the Congress consider these ways to provide consumer protections and encourage free and fair competition:

1. Additional Consumer Protections -- Clarify State and Federal Authority Over Wholesale Power Markets

Federal and state regulators should determine that a wholesale generator's contract was market-tested through an arms-length negotiation or other competitive process and there was no abuse of market power.

a. Clarify State Authority

We believe that the states can best protect consumers in their state. We propose that state regulatory commissions should have the unambiguous authority to veto projects which may harm consumers or undermine the competitive process.

The state public service commission with jurisdiction over the utility which purchases from an EWG should make a finding that there is a need for the capacity to be supplied by the EWG, that the EWG is the most appropriate option for supplying that capacity, and that the EWG's contract is consistent with market-pricing and least-cost or resource planning goals. In the first two findings, the state commission would simply apply its prudence standards; in the third, it is performing its role as guardian of the integrity of a free and fair procurement process in its state.

In addition, the EWG must show that the state commission with jurisdiction over any utility investor has instituted a system or process for monitoring and remedying cross-subsidies between the utility and its unregulated subsidiaries. This finding need not be specific to the EWG or a particular transaction. The EWG would only need to show that such a system was in place.

b. Clarify FERC's Authority

First, for an EWG, FERC should certify that the contract price of its power is consistent with free and fair competition, and would therefore be just and reasonable under Sections 205 and 206 of the Federal Power Act. In practice, we contemplate that where state review of potential market power abuse was thorough, FERC's just and reasonable review would be limited.

FERC should also have a clear statutory mandate to approve market-pricing of wholesale transactions as just and reasonable where there is no potential for market power abuse. Moreover, FERC should also have an authority to condition such approval in any way it finds necessary and appropriate for free and fair competition.

Second, for power markets to become truly competitive, transmission access and pricing must be both available and fair to wholesale generators. Transmission access for all suppliers is critical to get their product to market and allow those utility customers who have invested in the transmission system to reap the benefits of free and fair competition.

FERC's authority to order wheeling under Sections 211 and 212 of the Federal Power Act should be strengthened and expanded. FERC should have the authority to mandate wheeling by any utility which uses its transmission system to buy or sell electricity in competitive wholesale markets, if FERC found that the utility had unreasonably withheld transmission services with anti-competitive purpose or effect. These wheeling orders should be fair to the utility customers who own the transmission system and not jeopardize the reliability of the system.

c. Prohibit Hybrids of Rate-Based Facilities

PUHCA amendment should exclude hybrid EWGs where a part of the facility is rate-based and a part is not. This would help prevent cross-subsidy which might be more difficult to detect when a facility, wholly-owned by a utility, is partially in, and partially out, of rate-base.

2. Easing Unnecessary Regulatory Burdens

a. Permit State Option of Limited Retail Sales

Incidental retail sales by EWGs should be allowed to the extent permitted under state law. Under existing law, some states permit QFs to make limited retail sales. A similar distinction was adopted by Congress as part of the Clean Air Act Amendments' definition of an independent power facility.

b. Exempt EWGs From State Utility Law Where Appropriate

EWGs without utility ownership interest should be given the same exemption given to QFs from state utility statutes regulating financial and corporate matters.

This would give independents relief from the state utility statutes which impose financial and corporate organizational restraints on entities which fall within the state "utility" definition.

Until such time that wholesale transmission reforms make markets truly competitive, additional protections are appropriate. A protection which Congress should consider is to limit ownership in a wholesale generator by franchised utilities to 50 percent or less. This recommendation is intended to follow the limitations on utility ownership of generation facilities which exist now under PURPA and PUHCA. Under current PURPA rules, a utility's economic interest in a QF is limited to 50 percent after commercial operation. Under current PUHCA rules, a utility holding company may own 100 percent of a generation facility until the date of commercial operation, at which time its interest would have to be reduced to 10 percent or less (in the case of more than one facility). Increasing utility ownership to 50% would provide the utilities the same ownership for EWGs as for QFs.

C. Title XV Can Be Strengthened to Promote International Sales

Companies should be permitted to own EWGs abroad without restriction. EWG facilities should be permitted to be located outside the United States without restriction or condition. This would allow US owners of EWGs or QFs who wish to own or control generation facilities as part of a holding company structure outside the United States to do so without coming under the jurisdiction of the PUHCA.

V. CONCLUSION

NIEP believes that PUHCA reform structured to prevent abuse of market power and promote free and fair competition offers maximum flexibility to utilities, on behalf of their ratepayers, and the states which regulate them, to select the kind of power which best meets their needs. Participation in wholesale generation markets is voluntary. Utilities who need new capacity, in conjunction with their state regulators, would be free to decide whether or not they want to:

- buy power from a wholesale generator;
- participate in wholesale generation markets; or
- build their own cost-of-service plant.

In short, PUHCA reform will give utilities additional supply options to consider in meeting their ratepayers' needs without closing any existing ones. By exempting wholesale generators from regulation under PUHCA, Title XV of S.341 will create the opportunity for competition in power markets to flourish. We believe that the legislation can be strengthened and perfected by adopting provisions to protect more fully against anti-competitive and anti-consumer abuses. The goal of increased efficiency through competition could quickly be subverted if measures are not in place to protect markets against entities possessing market power. We also recommend that the legislation explicitly provide for an exemption for independents which wish to own and operate electric facilities abroad.

Reform of PUHCA will lead to greater efficiency, save consumers billions of dollars over the next decade, and make our industrial and manufacturing sectors more competitive internationally. It will also allow independents to invest in and operate plants overseas. It will give regulators better market information in protecting ratepayers and give utilities more options in meeting their supply needs.

We look forward to working with Members of Congress in achieving a more efficient and secure energy future for the United States.

The CHAIRMAN. Thank you very much, Mr. Elston.

Mr. Hempling.

STATEMENT OF SCOTT HEMPLING, ON BEHALF OF THE ENERGY PROJECT, ENVIRONMENTAL ACTION FOUNDATION

Mr. HEMPLING. Thank you very much, Mr. Chairman.

I appreciate this opportunity to appear before you again and I commend you and the committee for initiating this historic debate.

Mr. Chairman, the generation and transmission sectors in our industry are marked by systematic, anti-competitive practices. If we want to enhance competition, we must address those practices.

Title XV assumes them away. Worse, title XV rewards anti-competitive practices by freeing the practitioners to expand into new territories without review.

Our industry also is marked by great uncertainty over the quality and predictability of regulation. No one is sure who has jurisdiction over which types of transactions. No one is sure if regulators have the tools they need to monitor a rapidly restructuring industry.

Title XV assumes this problem away as well. We cannot assume strong competition in an industry which is anti-competitive. We cannot assume reliable regulation in an industry which is fast becoming unregulated. Broader legislation is difficult to imagine.

I turn now to some specific problems presented by title XV. Title XV would permit any company in any line of business to buy wholesale generators, as many as they desire, anywhere they desire, using almost any type of financing they desire, and face no advance review.

This regime would produce five major problems. The first is the self-dealing you have heard much about today. Title XV would multiply the abusive self-dealing, which has occurred under PURPA, as utilities acquired qualifying facilities outside the rules of the Public Utility Holding Company Act.

Second, self-dealing of another kind. The ownership by construction contractors, fuel sellers, and others who would self-deal with the wholesale entities which they control.

Third, evasion of State regulation. Given the current uncertainty over Federal/State jurisdiction, utilities still can use corporate form to avoid State regulation at the very point in history when States are using innovative methods to encourage efficiency and reduce costs.

The opt-out provision, which is newly in this proposal, enables a utility who is unsure of its ability to meet competition to decide unilaterally to prevent that competition simply by filing a declaration. That provision, not only erases traditional State regulation, it authorizes a violation of the fundamental utility obligation to operate at least cost.

Fourth, title XV would enable the use of transmission monopolies to create generation monopolies. Title XV fails to distinguish between two types of entities. The true independents, such as those represented by Mr. Elston, who are entrepreneurs who raised and risked their own capital, unassisted by control of a distribution or transmission monopoly on the one hand. And on the other hand, entities which are financed, owned, and controlled by utilities with monopolies over transmission facilities.

Mr. Chairman, transmission facilities are the highways of commerce in this industry. We will not have competition generation on a permanent basis if competing sellers cannot move their products to market, or if buyers cannot access the least expensive product.

Fifth, title XV would permit the unlimited mixing of utility and nonutility businesses. A key component of consumer protection in today's industry, is the separation of utility and nonutility businesses, although there are some exceptions. Title XV would breach that wall.

I would like now to rebut two separate arguments that I have heard in favor of title XV. First, proponents of title XV argue that State regulators can detect and correct all consumer and competitive abuses. State regulators disagree.

Speaking of consumer's power company in Michigan, the Hon. Ronald Russell of the Michigan Public Service Commission recently explained how "Corporate structure and transactions between corporate affiliates can be manipulated to embrace the concept of competitive generation while insuring that all competitive advantages reside with the holding company affiliates."

Commission Russell concluded that, "The situation can only get worse if revisions to the Holding Company Act encourage all of our electric utilities to emulate consumer's power company. The key to mitigating utility abuses is to prevent them from happening in the first place."

Second, we have heard about trends towards voluntary transmission access. Mr. Chairman, transmission access cannot develop on a consensual basis when the negotiations are between monopolists and their captives. Moreover, I believe utilities interests in voluntary transmission access will last only as long as the excess generating capacity it is intended to market. There will be less transmission access when there is less generation excess.

Now, Mr. Jordan and Mr. Smith, as I understand it, support the statutory status quo. Under that status quo, utilities use their control over transmission to lock out their competitors. Under that status quo, utilities, some of them, criticize independent cogenerators, then they self-deal with affiliated cogenerators, costing ratepayers hundreds or millions of dollars. Some change, clearly, is necessary.

But title XV is not that change. The appropriate change should have six, simple components: preclude self-dealing; grant transmission access rights to the most efficient deals, subject, of course, to transition rules which protect the native load customer; limit mergers and acquisitions to the least-cost proposals; rationalize State and Federal jurisdiction; require least-cost planning at the Federal Energy Regulatory Commission; and limit investment by utilities in nonutility enterprises.

In conclusion, Mr. Chairman, the question is not whether we should have more competition in generation markets. Everyone agrees with that proposition, except some utilities who fear competition. But we must not confuse more competitors with more competition.

Some, in this debate, cast the issues as a debate over two worlds, the world of competition represented by utilities supporting title XV. And the world of no competition represented by the utilities opposing title XV.

There are, in fact, three worlds. No competition, unfair competition, and fair competition. I believe title XV is unfair competition. It authorizes monopolization, a temporary rivalry among entities with growing market power. Title XV may add competitors in the short run, but it will not add competition in the long run.

Mr. Chairman, I appreciate this opportunity to present my views.

[The prepared statement of Mr. Hempling follows:]

TESTIMONY OF

SCOTT HEMPLING
ATTORNEY

ON BEHALF OF

ENERGY PROJECT
ENVIRONMENTAL ACTION FOUNDATION

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

ON
TITLE XV OF THE NATIONAL ENERGY SECURITY ACT OF 1991:
AMENDMENT OF THE PUBLIC UTILITY HOLDING COMPANY ACT

March 14, 1991

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EXECUTIVE SUMMARY

Title XV would enact the most drastic structural change in the electric industry in over 50 years. It would weaken the core of the statutory protector of consumers and competition: the Public Utility Holding Company Act of 1935 ("PUHCA" or "the Act").

1. Title XV will lead to reduced competition, reduced regulatory oversight, and unlimited mixing of utilities with nonutility businesses. Title XV would permit any company in any line of business to enter the market anywhere, acquire as many wholesale utilities they desire, and face no advance review under PUHCA.

Title XV fails to distinguish between two types of entities: (1) entities financed, owned and controlled by utilities with monopolies over distribution or transmission markets; and (2) "true independents;" _i.e._, those entrepreneurs who raise and risk their own capital, unassisted by a distribution or transmission monopoly. Instead, it creates an artificial category, "exempt wholesale generators," sweeps both kinds of entities into it, and exempts them from every provision of the Act.

By authorizing the creation of utility affiliates without review, Title XV would multiply the abusive self-dealing which occurred when utilities acquired "qualifying facilities" under the Public Utility Regulatory Policies Act. Utilities also could use their captive customers to subsidize expansion into new territories. In particular, utilities could use their transmission monopolies to create generation monopolies. Title XV adds competitors, but it does not add competition.

Title XV also would invite utilities and others to use corporate form to preempt state regulation, at the very point in history when states are using innovative methods to encourage efficiency and reduce costs.

2. Supporters of Title XV hope that after-the-fact regulation will protect consumers from abuse. These hopes ignore the history of this industry. When before-the-fact structural protections are in place, abuse is minimized; absent these rules, utility regulation becomes a laborious, expensive, and unreliable effort to detect cross-subsidies and other abuses. As Commissioner Ronald Russell of the Michigan Public Service Commission has stated, "corporate structure, and transactions between corporate affiliates, can be manipulated to embrace the concept of competitive generation while insuring that all competitive advantages reside with holding company affiliates."

3. To "reform" the electric industry, Congress must eliminate current anticompetitive behavior and jurisdictional forum-shopping. Only then will Congress be able to harness the new forces of competition.

Mr. Chairman and Members of the Committee:

My name is Scott Hempling. I am an attorney in private practice in Washington, D.C. I am appearing on behalf of the Energy Project of Environmental Action Foundation ("EAF"). EAF is a nonprofit, research and education organization concerned with energy and environmental issues. I have represented consumer interests in electric industry restructuring litigation, including many of the recent major industry initiatives. In particular, I have participated in numerous proceedings under the Public Utility Holding Company Act of 1935 ("PUHCA" or "the Act"). I have written several articles on the Act and on other aspects of the electric industry.

I commend the Chairman for his leadership in initiating this historic debate on the changing electric industry. I appreciate this opportunity to participate in that debate and, in particular, to analyze on behalf of consumers the implications of Title XV, concerning modification of the Public Utility Holding Company Act.

INTRODUCTION

Title XV would enact the most drastic structural change in the electric industry in over 50 years. Title XV poses as a "narrow fix." But broader legislation is difficult to imagine.

Today's electric industry is marked by systemic anticompetitive practices in the generation and transmission sectors. In order to enhance competition, we must address these practices directly. Title XV assumes them away. Worse, Title XV rewards anticompetitive practices by freeing the anticompetitors to expand into new territories, free of existing consumer protective regulation.

Today's electric industry also is marked by great uncertainty over the quality and predictability of regulation. No one is sure who has jurisdiction over which types of transactions. No one is sure if regulators have the tools necessary to anticipate and meet the new challenges posed by a rapidly restructuring industry. Title XV assumes this problem away as well.

We cannot assume strong competition in an industry which is anticompetitive. We cannot assume strong regulation in an industry which is fast become unregulated. Title XV makes both errors.

The Public Utility Holding Company Act is the essential statutory protector of competition and consumers. Among other things, the Act --

1. Bars utility acquisitions which monopolize new territories or new power sources, or which create risks

to consumers or investors. See Section 10(b)(1), (2), (3).

2. Demands that utility acquisitions "serve the public interest by tending toward the economical and efficient development of an integrated public-utility system." See Section 10(c)(2).

3. Limits utility speculation in unrelated ventures (e.g., banks, real estate, distant utility businesses), where that speculation imposes risks on electric customers. See Sections 1(b), 11(b)(1).

PUHCA played a central role in breaking up the large holding companies that once plagued the nation. But the tendency toward concentration has not disappeared. As the Honorable Ronald Russell of the Michigan Public Service Commission has stated, "[h]uman nature has not changed since the 1930s." [1]

Title XV ignores that simple fact. By repealing key protections in the Public Utility Holding Company Act, Title XV would leave consumers, competition and regulation substantially unprotected from utility monopolization.

Yet the status quo is not adequate either. Under the status quo utilities use their monopoly power over transmission facilities to deny competitors nondiscriminatory, economic access to wholesale markets, at the same time that the utilities themselves expand into those very markets by evading key provisions of PUHCA. Some change clearly is necessary.

My testimony has four parts.

Part I explains that Title XV will lead to reduced competition, reduced regulatory oversight, and unlimited mixing of utilities with nonutility businesses.

Part II argues that utilities supporting Title XV ignore the reality of competition and regulation in today's industry.

Part III argues that utilities opposing Title XV hope to avoid competition and regulation.

Part IV presents a two-part plan for bring true reform to the electric industry.

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[1] Commissioner R. Russell, "Who Needs PUHCA?", Speech Before the American Bar Association, Section of Natural Resources, Energy and Environmental Law (Mar. 8, 1991) [hereinafter cited as "Comm. Russell Speech"].

I. TITLE XV WILL LEAD TO REDUCED COMPETITION, REDUCED REGULATORY OVERSIGHT, AND UNLIMITED MIXING OF UTILITIES WITH NONUTILITY BUSINESSES

A. Overview

Many utilities want to restructure in order to dilute or avoid state regulation, compete unfairly against "true independents," and siphon efficiency savings from ratepayers to shareholders. The Act substantially blocks or inhibits these restructuring plans. Consequently, the utilities want the Act eliminated. But instead of candid calls for repeal, utilities create corporate constructs which "exempt" them from the Act. Utilities don't expand; they create "independent power producers." A utility affiliate acting as an "independent affiliate" is an oxymoron. What is the affiliate independent of? When a utility with a distribution or transmission monopoly creates, finances, owns and controls another company, that company is not independent.

Title XV ignores this distinction. It fails to distinguish between two types of entities: (1) entities financed, owned and controlled by utilities with monopolies over distribution or transmission markets, and (2) "true independents," *i.e.*, those entrepreneurs who raise and risk their own capital, unassisted by a distribution or transmission monopoly. Instead, Title XV creates an artificial category, "exempt wholesale generators," sweeps both kinds of entities into it, and exempts them from every provision of the Act. These corporations could enter the market anywhere, acquire as many wholesale utilities as they desire, and face no advance review under PUHCA.

The question presented by Title XV is not whether we should encourage more competition in generation markets. Everyone agrees with that proposition, except some utilities fearful of that competition. The real question presented by Title XV is this:

> **Should we permit electric utilities with monopoly retail franchises or monopolies over strategic transmission facilities (or both) to create or acquire power supply subsidiaries, without advance federal review of the implications for consumers, competition, efficiency or state regulation?**

The answer must be "no."

This Part I describes six adverse results of Title XV:

Recent History is Undisputed: Creation of Utility Affiliates Without Review Leads to Self-Dealing Which Weakens Competition and Consumer Protection

Utilities Can Use Corporate Form to Preempt State Law and Regulation

Utility Affiliates Can Use Their Transmission Monopolies to Create Generation Monopolies

Utility Ownership by Construction Contractors Will Create New Biases In Favor of Risky Construction, and Against Low-Risk Conservation and Load Management

Diversification -- The Unlimited Mixing of Utility and Non-Utility Business -- Will Increase Consumer Risks

The Restructuring Permitted by Title XV Can Lead the Nation Away from Environmentally Protective Power Supply Alternatives

B. Recent History is Undisputed: Creation of Utility Affiliates Without Review Weakens Competition and Consumer Protection

1. Creation of Utility Affiliates Leads to Harmful Self-Dealing

a. Utility Self-Dealing Equals Consumer Abuse

Abusive self-dealing occurs when the customers of the monopoly utility pay a supramarket price for a service or good supplied by an affiliate because there was no unaffiliated competitor to provide the service or good. Self-dealing is fundamentally inconsistent with the utility's obligation to serve the public at least feasible cost.

Assume a new low-cost generation opportunity appears within a utility's service territory. The parent utility with the retail monopoly should exploit this opportunity for its customers. Instead, if the parent utility has an affiliate it will channel this opportunity to its affiliate. The affiliate will then produce the low-cost power, and sell to the parent utility at the parent's higher avoided cost. As a result, the captive retail customers pay a marked-up price. In effect, the utility has diverted savings from captive customers to shareholders.

In the above scenario, the parent utility has also violated principles of fair competition. In a free market, competition would push the retail price down to the level of the most efficient seller's production cost. But in the case of a franchised utility, where there is no competition at retail, the price remains at the utility's avoided cost. The difference is monopoly rent.

b. Utility Self-Dealing Plagues the Industry Today

The creation of an affiliate by a utility, followed by the utility's purchase of electricity from that affiliate to serve the utility's own retail load, is a relatively recent phenomenon. Until 1978, a utility could not create or acquire more than one such affiliate without first satisfying the "advance review" tests of the Act. These tests effectively barred a utility from creating an affiliate to supply power that the utility could supply itself.[3]

In 1978, this statutory scheme changed dramatically. The Public Utility Regulatory Policies Act of 1978 ("PURPA") created a category of generating utilities known as "qualifying facilities." Pursuant to Congressional authorization, the Federal Energy Regulatory Commission ("FERC") then excepted these entities from PUHCA on a blanket basis. FERC also permitted traditional utilities to own up to 50% of any qualifying facility. Due to this blanket exception, a traditional utility now may create or acquire an unlimited number of generating utilities without satisfying the advance review tests of PUHCA, provided the generating utilities are "qualifying facilities" under PURPA.

Many traditional utilities have created PURPA affiliates, and then purchased power from those affiliates at prices higher than the cost the utility would have incurred had the utility produced the power itself. The transactions between utilities and their affiliates, nonreviewable by the SEC under PUHCA, have engendered much controversy. The problem was summarized aptly by the Michigan Public Service Commission when it described last summer an interaffiliate contract involving Consumers Power:

> One must wonder whether Consumers has once again negotiated with itself and lost.

U-8871, Order of June 22, 1989 at 31.

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[3] Sections 9 and 10 of PUHCA, 15 U.S.C. sec. 79i and 79j, required the utility to make an affirmative showing to the U.S. Securities and Exchange Commission ("SEC") that the acquisition (1) would produce economies and efficiencies for the utility's ratepayers by "integrating" the acquired assets with the utility's existing assets, (2) would not create the potential for anticompetitive behavior, and (3) would not result in corporate structures that complicate state regulation.

An Appendix to my testimony presented to this Committee in November 1989 contained case studies of utility affiliate problems involving Southern California Edison, Consumers Power, Florida Power Corporation, Tucson Electric Power, Sierra Pacific Power, Ohio Power, Columbia Gas System, Arizona Public Service, Niagara Mohawk Power Corporation, Central Illinois Public Service Company, Montana-Dakota Utility Company, and Public Service Company of New Mexico. These case studies reveal the following abuses, among many others:

1. Utility pays excess capacity charges to its affiliate.
2. Utility pays the salary of the affiliate's negotiating team.
3. Utility imposes onerous contract terms on nonaffiliates but not on affiliate.
4. Utility buys gas at two different rates; assigns high-cost gas to itself and low-cost gas to its affiliate.
5. Utility grants transmission access to its affiliate but denies it to unaffiliated competitors.
6. Utility pays prices to its coal subsidiary in excess of market prices.
7. Utility ships its coal over its transportation affiliate's rail lines for a price exceeding that of alternative rail lines.
8. Utility obligates itself to buy more capacity from its affiliate than it needs.
9. Utility affiliate's business risks inflate the cost of capital for the utility.
10. Utility hires its affiliate to act as sales broker to sell utility land to the affiliate.

In the present testimony, I attach an Appendix A which details, based on more recent information, the abuses committed by Consumers Power Company. Consumers Power's activities exemplify the anticompetitive and anticonsumer results of freeing a utility to create affiliates and self-deal with them.

c. Title XV Will Make Self-Dealing Worse

Title XV repeats the PURPA error of permitting utilities to form affiliates without review under PUHCA. And Title XV does more: it directly eliminates existing protections against self-dealing. Under Title XV, an "exempt wholesale generator" (EWG) is deemed not to be an "electric utility" under PUHCA. A utility therefore can acquire unlimited numbers of EWGs in many states. Under PUHCA today, a holding company with wholesale utility subsidiaries spread across several states would be a registered holding company, like Entergy or American Electric Power. Under today's Act, a registered holding company would be subject to the monitoring provisions of Sections 13, 14 and 15 for interaffiliate transactions. But since an entity owning EWGs would not be a registered holding company under Title XV (it would not be a "holding company" at all because it owns no "electric utility"), the entity would not be subject to Sections 13, 14 and 15. In short, an entity whose self-dealing would be monitored under today's Act would not be monitored under Title XV. The difference is stark.

2. Utilities Can Use Their Captive Customers to Subsidize Expansion Into New Territories

From the perspective of captive retail customers, utility expansion into new markets raises the same problems as does utility diversification in general: risk of failure, diversion of utility profits from measures which would strengthen the utility's financial condition, reduced utility maintenance, the "draining" of top management from the core utility, and cross-subsidization.

A company cannot argue, simultaneously, that (1) it has resources and management skills that can benefit other territories, and (2) that it is retaining its best resources and management for the local utility business. Managers cannot be in two places at the same time.

C. Utilities Can Use Corporate Form to Preempt State Law and Regulation

1. The Problem of Preemption

In the 1970's, utilities initiated large capacity expansion programs, based on projection of high demand and moderate construction costs. These projections turned out to be wrong. Consequently, state regulators in the 1980's excluded a substantial amount of utilities' construction investment from retail rates. Disappointed with this treatment, utilities now seek to minimize future state regulatory scrutiny. One strategy is to shift regulatory review from the states to the Federal Energy Regulatory Commission ("FERC"). To accomplish this, utilities are (1) creating generating affiliates and (2) successfully applying the developing constitutional doctrine of preemption.

In Mississippi Power & Light v. State of Mississippi, 487 U.S. 354 (1988), the U.S. Supreme Court held that FERC's allocation of power plant construction capacity among the utility subsidiaries of a centrally planned holding company preempted state commission review of the utility subsidiaries' decision to participate in that construction. The decision places the future of state regulation in doubt. This uncertainty applies to such innovations as least cost planning and competitive bidding for new generation, as well as the more traditional prudence reviews.

The law in this area is very uncertain and still developing. Federal legislation may be necessary to clarify the states' future role. Until that clarification occurs, any proposal to ease the creation of utility affiliates by repealing PUHCA is suspect.

2. The "Opt-Out" Provision in Title XV Exacerbates Preemption: Utility Monopolies Can Evade Competition and Regulation Simply by Filing a Declaration

Section 15003 of Title XV would permit utility monopolies to override their state regulators and insulate themselves from competition. For ten years, a utility could declare its refusal to buy from EWGs, even if the EWGs offered power less expensively than the utility's own production. The utility's declaration, when filed at FERC, would preempt state regulators from challenging the utility's imprudence. Thus a utility, unsure of its ability to meet competition could decide unilaterally to prevent it.

The provision not only erases traditional state regulation; it authorizes a violation of fundamental utility obligation. All utilities are obligated to provide their rate payers with the lowest cost, reliable power available. [3] This obligation includes engaging in all possible coordination transactions, including purchases from lower cost generators.

D. Utilities Affiliates Can Use Their Transmission Monopolies to Create Generation Monopolies

Transmission facilities are the highways of commerce in the electric industry. Competition in generation will not exist unless competing sellers can move their products to market and buyers have access to the least expensive product. The owner of a major transmission facility can create a "bottleneck" by denying access to all but its own affiliates. The major "bottleneck" facilities are owned by investor-owned companies with retail monopoly franchises.

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[3] See Midwestern Gas Transmission Co., 36 F.P.C. 61, 70 (1966) (utility is obligated to "utilize all available cost saving opportunities"), aff'd sub nom., Midwestern Gas Transmission Co. v. FPC, 388 F.2d 444 (7th Cir.), cert. denied, 392 U.S. 928 (1968); El Paso Natural Gas Co. v. FPC, 281 F.2d 567, 573 (5th Cir.) ("It is the obligation of all regulated public utilities to operate with all reasonable economies."), cert. denied, 366 U.S. 912 (1960).

Title XV ignores this fact. Free from PUHCA's restraints on unlimited expansion, utilities can (1) create affiliates to serve distant markets, (2) grant preferential transmission access to the affiliates, and thereby (3) prevent others from competing in those markets. Utilities have practiced this type of discrimination for years. PUHCA amendment and transmission access is linked, inseparably, by the reality of this industry.

E. Utility Ownership by Construction Contractors Will Create New Biases In Favor of Risky Construction, and Against Low-Risk Conservation and Load Management

Title XV would permit construction contractors and fuel suppliers to own the very utilities they supply. This type of ownership structure can stifle competition in the market for construction goods and services. Only those contractors wealthy enough to buy stock in new power supply ventures will be able to bid for project work. Other suppliers of engineering and construction services, fuel and financial skills may be more highly skilled; but if they are less wealthy or less well-connected, they will be locked out.

The risks of utility participation in so-called "independent power producers" are amply demonstrated in an SEC case, Sierra Pacific Resources, Release No. 35-24566 (Jan. 28, 1988). In that case, 85.5% of an "independent power producer" was to be owned by the contractors responsible for building the new plant. The newly acquired utility would commit hundreds of millions of dollars to plant construction without competitive bidding. Contractors were selected not for their skill, efficiency, or experience, but for their willingness to finance a new power marketing venture. For example, two coal producers each would own 9.5% of the project. Each will supply exactly one-half the coal for the new power plants. Observers wondered why precisely one-half the coal came from each of two competitors; i.e., why one company did not underbid the other and obtain all the business?

Future opportunities for such abuse will grow if the Public Utility Holding Company Act is amended to permit construction contractor ownership without SEC review.

F. Diversification -- The Unlimited Mixing of Utility and Non-Utility Business -- Will Increase Consumer Risks

A key component of the today's electric industry is the separation of utility and nonutility businesses. Utilities generally cannot invest in savings and loan institutions, and vice versa. Under Title XV, all that will change. [4]

As the Honorable William D. Steinmeier, Chairman of the Missouri Public Service Commission, has explained:

> Under PUHCA today, Section 1(b)(1)'s nondiversification rule prevents a multistate utility holding company from investing in nonutility businesses. But under S.406 [the predecessor to Title XV], a holding company could own EWGs across the nation and, because these EWGs would not be treated as "utilities," be free of the nondiversification rule application to a utility holding company.
>
> What is impermissible under PUHCA today -- multistate structures with investment in both utility and nonutility businesses, and the accompanying risks of cross-subsidies among them -- would be permissible under S.406. There would be no limits on the size, geographic scope, or type of business engaged in by these structures. Due to the unlimited interstate nature of these new entities, individual states will be hard-pressed to monitor, let alone detect and ferret out cross-subsidies and other abuses. [5]

G. The Restructuring Permitted by Title XV Can Lead the Nation Away from Environmentally Protective Power Supply Alternatives

"Qualifying facilities" under the Public Utility Regulatory Policies Act of 1978 (PURPA) tend to be smaller, cleaner and more efficient than traditional "central station" plants. Repeal of PUHCA would give a boost to non-QF options that are quicker to build, easier to finance, larger and less environmentally benign. For example, under Title XV an EWG need not own an entire facility, and the entire facility need not be devoted to wholesale generation. Therefore a utility could build a large coal or nuclear plant, use what electricity it needs for the captive customers, and sell the rest at wholesale through the EWG. There would be less incentive to build small plants that now qualify for PURPA.

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[4] Utility forays into nonutility businesses have had mixed results, at best. Arizona Public Service Company's affiliation with a savings and loan association, MeraBank, brought the parent holding company, Pinnacle West, to the brink of bankruptcy. This case is discussed in more detail below.

[5] W. Steinmeier, "Theory Meets Reality: The Case Against PUHCA Reform," The Electricity Journal 47 (January/February 1990).

H. Conclusion: Title XV Confuses "Competitors" With "Competition"

Some have suggested that the electricity debate is a debate over two possible worlds: "competition," represented by utilities supporting Title XV; and "no competition," represented by the utilities opposing Title XV. That viewpoint rests on a false dichotomy. There are in fact three possible worlds: "no competition," "unfair competition" and "fair competition." Title XV, which frees utilities to expand without review for anticompetitive purpose or effect, represents "unfair competition." Title XV may add competitors, add least temporarily; but it will not add competition.

II. UTILITIES SUPPORTING TITLE XV IGNORE THE REALITY OF COMPETITION AND REGULATION IN TODAY'S INDUSTRY

A. Individual States Will Have Severe Difficulties Regulating Corporate Structures Spread Across Many States and Many Industries

Proponents of Title XV argue that state regulators can detect and correct all consumer and competitive abuses. Past state regulatory experience proves the contrary. According to the Honorable Ronald Russell of the Michigan Public Service Commission, Michigan's experience with Consumers Power's QF affiliate provided a "unique opportunity to examine what the future would be like without the protections afforded by the Holding Company Act." [4]

Comm. Russell has explained that "corporate structure, and transactions between corporate affiliates, can be manipulated to embrace the concept of competitive generation while insuring that all competitive advantages reside with holding company affiliates." According to Commissioner Russell, Consumers Power and its parent, CMS Energy, have

> missed few opportunities to challenge or avoid the jurisdiction of the Michigan Public Service Commission....The Commission has been involved in over 30 court case related to jurisdictional challenges from

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[4] See Comm. Russell Speech, supra.

> CMS Energy or its affiliates.... The volume, complexity and expense of [this] litigation ... is unprecedented.
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> [CMS Energy] has used the holding company structure to interfere with state regulation of Consumers Power. Since becoming the utility's parent, CMS Energy and its unregulated subsidiary, CMS Enterprises Company, have actively opposed discovery, disclosure, and examination of their books and records. This has significantly complicated the Michigan Commission's ongoing investigation and monitoring of Consumers Power's financial stabilization program, as well as other efforts to ensure that transactions between Consumers Power and its affiliates are handled in an equitable manner. [7]

Commissioner Russell concluded that "[t]his situation can only get worse if revisions to the Holding Company Act encourage all of our electric utilities to emulate Consumers Power Company." He then stated (id.):

> After reviewing the litany of self-dealing abuses that characterized the record in the U-8871 proceeding, I, along with my fellow Commissioners, was moved to make the often quoted remark that '...one must wonder whether Consumers has once again negotiated with itself and lost." [U-8871 et al., Opinion and Order dated June 22, 1989]
>
> ... In view of the kind of activities we've seen in Michigan, I find it extremely difficult to understand how ... proponents of so-called "PUHCA reform" can deify the pursuit of competitive generation in the electric industry, while remaining apparently oblivious to the potential for interaffiliate abuses. Self-dealing and other anti-competitive activities not only could result in excessive retail rates, but also stand to subvert the new competitive regime by providing unwarranted subsidies and other advantages to a few "competitors" to the detriment of all others.
>
> ... The key to mitigating utility abuses is to prevent them from happening in the first place. The pre-acquisition reviews that are provided for in the Holding Company Act are intended to prevent the creation of corporate structures and transactions that are inherently susceptible to abusive behavior. The more complex the corporate relationships, the more difficult it becomes to detect abusive transactions.

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[7] Id.

> ... Creating exempt wholesale generator will not in and of itself stimulate a truly competitive market. Regulated utilities are the primary customers of the would-be wholesale generators. As long as they retain both the exclusive control of the national transmission system -- and the ability to opt out of the competitive marketplace -- utilities will retain all of the advantages that their monopoly positions give them plus they will gain new opportunities for configuring themselves to extract monopoly profits from their customers.
>
> Any legislation which removes virtually all restraints on a utility's ability to create numerous generating affiliates and partnerships -- without substantially strengthening the states' ability to address the concomitant anti-competitive abuses -- is untenable.

B. Voluntary Transmission Access Will not be Sufficient to Protect Against Abuse of Competition

Many utilities point to various "voluntary" transmission access proposals by utilities as a sign that the industry is moving to a transmission access regime without regulatory or legislative mandate. But "voluntary" access is voluntary for the "haves;" involuntary for the "have nots." Under "voluntary" access, the transmission monopolist provides service when it wants to; not when others need it. This option enables transmission owners to discriminate against their competitors.

Utilities' interest in "voluntary" access likely will last only as long as their excess generating capacity. Utilities like Public Service of Indiana have excess generating capacity that they wish to market at purportedly "flexible" prices. In order to win FERC approval of prices that depart from cost (i.e., prices which can produce extraordinary rates of return), these utilities must offer transmission access to those who otherwise would be forced to buy this high-priced power. When there is less generation excess, there will be less transmission access.

Freeing utilities to expand into other markets on the grounds of competition, without assuring the fairness of that competition, makes no sense. Yet utilities resist any effort to lodge, unambiguously, the duty to order such transmission access in any governmental entity. Utilities who benefit from the status quo of transmission control tell Congress that FERC should solve the problems growing out of that control. Then they argue to FERC that

Congress has denied them the tools necessary to do so. The positions are not consistent.

C. Regulation by FERC, and Residual Regulation by SEC, Will not be Sufficient to Protect Consumers or Competition

Some have argued that PUHCA is antiquated, because its protections are duplicated in other statutes. That argument ignores the quality of regulation today. FERC's wholesale rate regulation is inconsistent and unreliable; and the SEC's regulation under PUHCA is seriously flawed.

1. FERC's Wholesale Rate Regulation is Inconsistent and Unreliable

a. "Market-Based Pricing," Without Competitive Markets, Invites Consumer Abuse

In a dozen or so recent cases, FERC has abandoned cost-based, competitive pricing in favor of "market based pricing," even where no fair market is guaranteed. In its most extreme manifestation, FERC reasoning allows a new producer to build generation on the grounds that the price of the new generation is less than the utility's "avoided cost;" that is, the cost of other alternatives which the utility would otherwise pursue.

In none of these cases has FERC determined whether the avoided cost is a prudent avoided cost. In particular, FERC has disregarded conservation and load management as an alternative measures of avoided cost. In one case, all the Commission required was a certificate from the buyer, saying that the sales price did not exceed avoided cost. This "regulation-by-certification," without a proper market analysis, is not consumer-protective regulation.[8]

b. FERC's Recent Nevada Sun-Peak Decision is a Better Example of the Appropriate Review of Market-Based Pricing Proposals

In Nevada Sun-Peak Limited Partnership, Docket No. ER91-11-000, Nevada Sun-Peak, an affiliate of Southern California Edison, proposed to sell capacity to Nevada Power. Nevada Power had not conducted a competitive bid, formal or otherwise, on the grounds that there was no time to conduct one before Nevada Power's

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[8] See Citizens Power & Light Corporation, 48 F.E.R.C. para. 61,120 (1989). Contrast Baltimore Gas & Electric, 40 F.E.R.C. para. 61,170 at p. 61,538 (1987), where each avoided cost rate permitted by the Commission was a rate which the Commission previously had determined to be just and reasonable.

1991 peak arrived. Instead, Nevada Power approached two companies with whom it had dealt recently on PURPA projects, Westinghouse and Southern California Edison's affiliate, Mission Energy. Westinghouse concluded that it could not meet Nevada Power's schedule, leaving only Mission Energy.

Nevada Power and Mission Energy negotiated a contract, and submitted it to the Nevada Public Service Commission (NPSC) for approval. The NPSC rejected the contract initially, finding that Nevada Power had inadequately considered building a plant itself, and that the negotiated price did not produce the lowest revenue requirement of all available options. The parties returned with a renegotiated contract meeting these requirements and obtained NPSC approval. That contract then came to FERC for review.

At FERC, Sun-Peak did not attempt to justify the contract rate based on its own costs (as is customarily done in under a cost-based pricing regime). Sun-Peak instead asserted that it was entitled to the negotiated rate because it was negotiated within a competitive market. Sun-Peak claimed that the relevant market included "any company that is capable of constructing new capacity for Nevada Power;" i.e., most of the QF or independent power producer developers within the United States. The commission disagreed:

> Sun-Peak's argument that it competed against essentially all developers in the country capable of building CT units is no more than a theoretical proposition. Findings on generation dominance must be based on some evidence of actual alternatives available to the purchaser. Sun-Peak has presented evidence addressing only potential competition and has ignored the complete lack of evidence of actual competition. Nevada Power chose to look no further than Sun-Peak and, thus, there is no evidence that genuine alternatives (except self-construction) were available.

2. The SEC's Holding Company Regulation is Seriously Flawed

Recent SEC interpretations of its pre-acquisition review duties have left consumers at risk of utility corporate structures that encourage inefficiencies, forum-shopping, consumer abuse and anticompetitive behavior. I believe we cannot rely on the SEC's holding company regulators to administer what remains of the Act responsibly. [9]

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[9] A more detailed treatment of inadequate SEC enforcement appears in my article, "Corporate Restructuring and Consumer Risk: Is the SEC Enforcing the Public Utility Holding Company Act?" The

a. The Boundaries of PUHCA's "Intrastate" Exemption Evaporate Whenever An Interstate Electric Company "Transfers Title to Electrons" Within the State of Generation

The SEC has deemed "intrastate" a holding company structure with explicit plans to sell interstate. In the Sierra Pacific Resources case discussed previously, the construction consortium planned to sell electricity at wholesale to customers throughout the Western U.S. The Commission found that the consortium would be intrastate because the interstate contracts would be drafted so as to "transfer title to the electrons" at the plant site in Nevada. The notion that electrons are goods that are selected, owned, and transferred in identifiable lots has no basis in the law of PUHCA or the law of physics.

b. The SEC Has Disregarded the "Efficiencies and Economies" Requirement of Section 10(c)(2)

Section 10(c)(2) of PUHCA restricts holding company acquisitions to those which might bring actual operational benefits to its component parts from related operations and unified management.[10] On at least three occasions, the SEC has approved a type of restructuring where a shell corporation acquired the stock of an existing utility system, while making no change in the operations of utility assets. The third decision, involving Wisconsin Power & Light, was challenged in court by a consumer group I represented on the ground (among other grounds) that because the restructuring made no improvement in utility operations (WP&L had admitted as much), it could not satisfy Section 10(c)(2). In August 1989, the U.S. Court of Appeals for the D.C. Circuit

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Electricity Journal (July 1988).

[10] See, e.g., Electric Energy, Inc., 38 S.E.C. 658, 670-71 (1958) (Commission's approval rested on findings that the acquisition led to creation of an "operating committee" to "effectuate the efficient coordination of the generating facilities of [the to-be-acquired utility] with the generation, transmission and distribution systems" of the acquiring utilities; use of new microwave communication links to coordinate pre-planned power transfers among the new plant and the existing utilities; enhancement of the existing "power pool" relationship among three of the four acquiring utilities).

found that the SEC approval violated Section 10(c)(2). Wisconsin's Environmental Decade v. SEC, 882 F.2d 523 (D.C. Cir. 1989). [11]

c. The SEC Has Disregarded the "No Concentration of Control" Requirement of Section 10(b)(1)

Section 10(b)(1) of the Act requires the Commission to disapprove any holding company acquisition which "tend[s] towards ... the concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers." The Commission's analyses of the anti-competitive risks of recent holding company acquisitions bear little resemblance to rational antitrust analysis.

One example is Northeast Utilities' acquisition of Public Service of New Hampshire, Admin. Proc. 70-7695 (December 21, 1990). The Commission held that acquisitions were per se not anticompetitive because the post-acquisition entity was smaller than other holding companies in the nation. There was no analysis of relevant product market, relevant geographic market, concentration ratios or indices, or any of the other conventional or reliable factors used in antitrust analysis. The Commission essentially found that a merger would not dominate Market X because the merged company was smaller than companies in Market Y. No statute, court, agency, or commentator, in the history of antitrust law has ever analyzed a question of competition in this manner.

d. The SEC Has Ignored Its Responsibility to Protect Consumers From Harmful Utility Diversification

Another example of the SEC's failure to carry out its obligations to protect consumers and state regulation is the Pinnacle West debacle. Pinnacle West Capital Corporation is the parent holding company of Arizona Public Service. In 1986, Pinnacle West's corporate predecessor acquired MeraBank for $426 million. MeraBank was a Savings and Loan institution. According to the Arizona Corporation Commission, the $426 million price was two times MeraBank's book value; about 80% of the acquisition cost represented an acquisition premium, and was recorded on the books as good will.

As an exempt holding company, Pinnacle West was entitled to retain its exemption only "unless and except insofar as [the Commission] finds the exemption detrimental to the public interest or the interest of investors or consumers...." Section 3(a) of the Act. Several months before the acquisition, the SEC wrote to the holding company, requesting an explanation as to the rationale supporting the holding company's continued exemption in light of the proposed acquisition. The holding company responded that "MeraBank has an established record of continuing growth which will contribute favorably to the [holding company].... in no event may APS's financial resources be directly or indirectly committed or pledged to accomplish the acquisition." The SEC apparently accepted this explanation; I am aware of no further communications from the SEC to the holding company.

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[11] The Court remanded the matter to the SEC, and the parties now are disputing what type of improvements are necessary to satisfy the statute. The company continues to assert that no change in the operation of utility assets is necessary.

The SEC's acceptance of Pinnacle West's explanation, coupled with its failure to pay any attention to post acquisition developments, led to the largest diversification loss in the electric industry since the statute was enacted.

1. On December 31, 1988, MeraBank recorded a loss of $209 million, virtually cancelling out APS' net income that year and producing a 98% decline in Pinnacle West's net income as compared with 1987.

2. In November 1989, Moody's lowered rating on certain APS securities and indicated it will keep APS' securities on credit watch, direction uncertain. Moody's cited, among other factors, the potential for decreasing financial flexibility at APS due to the continuing liquidity problems of Pinnacle West and Pinnacle West's dependence on common stock dividends.

3. In December 1989, the Federal Office of Thrift Supervision and Pinnacle West entered into an agreement which released Pinnacle West from any continuing obligation to maintain MeraBank's financial soundness, in return for Pinnacle West injecting $300 million in cash into MeraBank, and agreeing to pay MeraBank another $150 million over a fixed period.

4. In order to borrow the money to bail out MeraBank, Pinnacle West pledged as collateral its only significant asset: 100% of APS's outstanding common stock. Pinnacle West, an exempt intrastate holding company, thus assigned the right to future ownership of a public utility to out-of-state financial interests without any advance notice to the Arizona Corporation Commission or the SEC's holding company regulators.

Throughout all these developments, which were widely reported in the press, the SEC's holding company regulators did nothing. Finally, on May 1, 1990, the Arizona Corporation Commission took the unprecedented action of filing a complaint and a petition to revoke or modify Pinnacle West's exemption on the grounds that the exemption had become "detrimental to the public interest or the interest of investors or consumers...." Section 3(a) of the Act. That document brought the entire matter to the SEC's formal attention. Ten months later, the SEC still has not acted.

e. The Commission's Decisionmaking Procedures are Biased Against Consumers and Inconsistent with Administrative Fairness

Proper enforcement requires not only adequate staffing, but procedures which ensure public participation and review. In this regard, the SEC's procedures are faulty, in several ways. The first example concerns utility proposals which trigger a notice in the Federal Register and an opportunity for public comment. In those cases, utility officials commonly meet with the SEC staff in advance of the notice to iron out details in private. Then when consumers file protests pursuant to the Federal Register notice, the very same staff advises the Commission to reject the consumers' concerns. This procedure is inconsistent with administrative fairness.

In numerous other cases, no Federal Register notice is triggered whatsoever. Instead, the utility and the staff meet privately, and agree on a corporate structure that does not, in the staff's view, implicate a specific provision of the statute. The staff then sends the utility a so-called "no-action" letter, stating the staff's expectation that it will take no action to oppose the proposal. The public has no opportunity to comment on whether the Act is implicated, and does not even learn about the utility transaction until afterwards, if at all. I am aware of no procedure by which consumer representatives, state regulators, or competitors may protest such action.

3. Utility Mergers and Other Forms of Utility Expansion Continue Without Adequate Regulatory Review

Together, the merger and acquisition provisions of the Federal Power Act and the Public Utility Holding Company Act should produce an electric industry which is locally managed and locally regulated. Utilities should be focusing on their core customers, providing the type of energy service most consistent with the customers' needs.

Utility actions over the past few years have scattered these principles to the four winds. Witness the following:

a. Utilities acquire other utilities, make the acquirees divisions rather than subsidiaries, and thereby escape review under PUHCA completely.

b. Utility and others acquire wholesale generating companies in remote locations using a limited partnership form rather than a new corporation, and similarly escape PUHCA. Southern California Edison and Mitsubishi are prime examples of this distant management.

c. After FERC's decision in the recent Missouri Basin case, utilities who form holding companies, and then merge, escape the Federal Power Act completely. [12]

The consequences of FERC's Missouri Basin decision are dramatic. In those circumstances where FERC does have jurisdiction over mergers, FERC has insisted that the merging entities demonstrate that the merger does not weaken competition. If the merger as proposed does weaken competition FERC will insist on transmission access and other conditions to mitigate any market power produced by the merger.

More generally, merger law as applied by FERC fails to distinguish between efficient mergers and inefficient mergers. Normally, we expect management to act to minimize costs for ratepayers. In a merger context, target company management has the opposite incentive. There appears to be no legal obligation to merge, even when a merger would produce efficiencies. Therefore, management of a target company has an incentive to refuse to merge until he obtains the highest possible price for his shareholders. That high price, if paid by the acquirer in the form of an acquisition premium, can burden ratepayers. [13]

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[12] See Missouri Basin Municipal Power Agency v. Midwest Energy Co. and Iowa Resources Inc., FERC Docket No. EL90-31-000, Order Noting and Granting Interventions and Dismissing Complaint, Dec. 13, 1990. See also D. Allen, "To FERC or Not to FERC, That Is the Question" The Electricity Journal 62-65 (January/February 1991).

[13] Regulatory policy on the acquisition premium does not steer a clear path through these issues. For example, FERC has not provided one clearly defined standard to apply to utility requests to recover and earn a return on an acquisition premium by permitting an acquisition adjustment. In a 1961 decision, the Commission asserted that it would permit an acquisition adjustment only if consumer benefits were (1) clearly traceable to the acquisition, and (2) not achievable without the acquisition. Gulf Energy & Development Corporation, 4 F.E.R.C. para 61,080 at p. 61,173 (1978). Assuming these first two tests were met, the Commission then would limit the amount of the adjustment to the dollar level specifically quantified by the acquirer.

However, in a 1988 decision, the Commission applied a more relaxed standard, considering only whether the acquisition was "prudent." Minnesota Power & Light Company and Northern States

D. Creation of Utility Affiliates is not Necessary to Produce the Benefits of Competition

1. Leveraging Benefits Alone Do Not Justify Creating Affiliates

Some argue that utilities should create affiliates because affiliates can use "leveraged" capital structures that produce lower costs. A leveraged structure has higher ratio of debt to equity than normal. Since debt costs less than equity, the argument goes, costs are lower. This argument does not stand up well to analysis.

Leveraging is not a free lunch. The higher the debt ratio, the greater the fears of investors -- both stockholders and bondholders -- that the entity lacks sufficient assets to pay dividends consistently, or retire the debt principle, during times of economic downturn. Owners of securities in the buying utility will be concerned that if the affiliate encounters financial difficult, the holding company parent will shift assets or funds from the utility to the affiliate, thereby weakening the utility. The utility's equity owners will demand some protection for that risk, in the form of higher returns. The money for those higher returns comes from captive ratepayers.

If leveraging were indisputably beneficial to consumers, utilities would leverage, and there would be no justification for the affiliate. But many states and their regulators are risk adverse, and do not want the utility to leverage. Under these circumstances, a utility who proceeds to create a leveraged affiliate and then buy power from that affiliate is simply circumventing the state's policy against leveraging.

2. Utilities With Skills to Spare Can Spin Off New Companies Rather Than Create Affiliates

Some argue that utilities should be free to expand so that they can export their experience and skill to new regions. This argument is wrong. If an existing utility has management to spare, it need not expand to new territories. It can transfer that management to a new company and spin off that company to its shareholders. In this way, other regions will receive the benefits of the excess skills and assets. There is no public interest

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Power Company, 43 F.E.R.C. para. 61,103 (1988). The Commission did not insist on any (a) quantification, (b) tracing of benefits to the acquisition, (c) a showing that benefits would not have been achieved without the acquisition, or (d) a limit of the acquisition adjustment to the level of benefits shown.

reason why the pre-existing utility need retain control of the new company.

The only argument against the spin-off option is that the original utility could not itself profit from these new ventures. That is precisely the point. The utility cannot serve two sets of customers, one captive and one competitive, without creating risks of abuse that currently are insoluble.

E. Title XV Makes No Distinction Between the Adjustments Entrants (1) Want and (2) Need

Proponents of Title XV complain about having to comply with PUHCA, but they rarely cite the provisions they find bothersome. Instead, they seek full exemption from all aspects of the Act. They make no distinction between the changes they want and the changes they need. More specifically, they fail to distinguish between _barriers_ and _burdens_.

In the case of true independents and traditional utilities, the only possible _barrier_ to entry is the "integration" aspect of Section 10(c)(2). Under that requirement, a holding company may not own more than one utility corporation unless all the utility assets operate together as a single integrated, coordinated system. Under the Act, a holding company may not own a utility subsidiary in Maine and a utility subsidiary in California; the two utilities never could act as a single coordinated system.

The barrier, if there is one, exists only if the utility chooses a corporate structure which places each project in a separate subsidiary. Is this choice necessary? Some say, "Wall Street requires it." Those who seek radical changes to the Act certainly must do more than say that "Wall Street" requires those changes.

Even if Congress does eliminate the _integration_ requirement of Section 10(c)(2), it need not relax the _improvement_ requirement. The improvement requirement is necessary to ensure that a single holding company does not merely expand for the sake of expansion; but that it expands because expansion improves the lot of ratepayers.

F. It is Virtually Impossible to Impose Real Risk on Wholesale Generators As Long As Distribution Customers are Captive

It is commonplace to welcome "independent power production" by saying that IPPs will bear risks of generator construction. IPP supporters contrast the 1970s' "cost plus" construction in which ratepayers bore the risk of all cost increases.

To expect all risks to sit with the risktakers in an industry of captive customers is to ask the impossible. The industry has not worked that way. Public Service of New Hampshire's investors took the risk of building a nuclear plant. When PSNH failed, the costs fell only partially on PSNH shareholders and creditors. A significant share of the cost -- hundreds of millions of dollars -- fell on PSNH's captive ratepayers, as well as other ratepayers in New England (who, under the NU-PSNH merger proposal, must forfeit existing coordination savings for the benefit of the merged company). When Consumers Power's Midland Nuclear plant failed, taking the company near bankruptcy, the company sought and received "financial stabilization rates": above-cost rates that never could be sustained in a competitive market. The savings and loan industry provides another example of transfer of risk. In that industry, the captives taxpayers were forced to cover the bets that investors took. In the utility industry the captives are, and always will be, the ratepayers.

The scenario is easy to imagine. If an IPP -- whether truly independent or utility-affiliated -- fails financially, it will not disappear into its bankers' portfolios. The plant occupied a key place in the buying utility's resource plan. It must continue to produce power. Someone must support the plant financially, and that someone must be the captive ratepayers. The fact that the generator is wholesale and the ratepayer is retail does not matter. In any industry with captives, risks are taken by producers but largely borne by the captives.

We all desire competitive wholesale markets. But retail markets are not competitive. They are controlled franchised monopolists and their customers are captive. Competition means winners and losers. If utilities are going to venture into competitive wholesale markets, there must be some means of protecting their captives from loss.

III. UTILITIES OPPOSING TITLE XV ALSO HOPE TO AVOID COMPETITION AND REGULATION

Posing as allies of the consumer, some utilities have attacked Title XV. These utilities assert that the introduction of new generating entities will destabilize an industry which is functioning smoothly. I urge this Committee to reject those arguments and not to confuse these utilities' interests with the consumer interests.

These utilities argue first that the "current system of regulated, vertically integrated electric utilities had provided the United States with the most reliable and economical electric service in the world." See, e.g., D. Jordan, "The Hidden Threat," Public Utilities Fortnightly at 27, (Mar. 15, 1991). They are wrong. The recent history of this industry is not good. This industry's overinvestment in billions of dollars in baseload generation in the 1970s has been criticized by every objective observer, including Forbes magazine (Feb. 11, 1985).

The utilities' response to this criticism has been that state regulators did not uphold the so-called "regulatory compact". By "regulatory compact" these utilities mean recovery from captive ratepayers of all investment in generation; prudent or not, uneconomic or not. What social compact? The U.S. Supreme Court recently rejected a claim by Duquesne Lighting Company that it was entitled to a profit on $50 million invested in an abandoned plant. The Pennsylvania Commission, upheld by the Pennsylvania Supreme Court, protected ratepayers from this investment because it was useless. The company argued that it had a constitutional right to the return, based on this ephemeral social compact. The Court disagreed. Duquesne Light Company v. Barasch, 488 U.S. 299 (1989).

No utility ever has pointed to a specific clause, law, contract, compact, or other document which protects utilities from the risks of the marketplace or the risks of their own imprudence. If there is any social compact in this industry it is that those who take responsibility for profits also must take responsibility for costs.

These utilities also object to the major premise of this debate: that competition in generation will assist regulation. These utilities claim no aversion to competition. As Mr. Jordan wrote (id. at 28.), "we have always dealt squarely with the forces of the marketplace." When? This industry, including Mr. Jordan's company, has consistently objected to granting fair access to the transmission highways on economic terms. Every fuel source used by this industry -- coal, gas, oil and nuclear -- is subsidized by someone: another region may pay for spillage, a future generation may pay for pollution clean up, federal taxpayers may support research and development, and everyone may support the cost of a nuclear accident in excess of the ceilings stated in the Price-Anderson Act. We do not have competition in the industry today.

Mr. Jordan states (id.) that "[i]f true competition is really the goal ... then all power producers should be subject to the same regulatory oversight. That would be real competition." I accept that challenge. As soon as Mr. Jordan and his colleagues are ready, we can sit down and design a system of regulation that treats all entities the same. That means of course, that those who control non-duplicable transmission facilities may not parley that control into permanent monopolies over generation resources and transmission highways. It means that some utilities should not use power supplies subsidized by future generations or other regions.

When we assure access to the highways and eliminate subsidization of fuels, "that would be real competition."

These utilities also argue that independent generators are less reliable than traditional utilities because the independents are bound by contracts only, not franchises. That is circular reasoning. We can bind wholesale generating entities to a franchise obligation just as we bind distribution utilities.

IV. TO ENSURE FAIR COMPETITION AT ALL LEVELS OF THE INDUSTRY, CONGRESS MUST CORRECT CURRENT PROBLEMS AND HARNESS THE FORCES OF COMPETITION

To "reform" the electric industry, Congress must take two major steps. First it must solve current problems. Next, it must harness the forces of competition. Each step is discussed below.

A. Solutions to Current Problems

1. Preclude Self-Dealing

It should go without saying that utilities cannot be permitted to form affiliates which sell power back to the utilities. That is not utility expansion, but utility siphoning. The ban on self-dealing should apply to utility-owned QFs as well as other wholesale generators.

What about "reciprocal dealing"? "Self-dealing" should be defined to include "reciprocal dealing." Assume a Virginia utility creates an affiliate that sells to a California utility. Assume further that the California utility creates an affiliate to sell to the Virginia utility. Finally, assume that each affiliate is producing at a cost below its affiliated utility's cost. In these transactions, both utilities may be overpaying for power, if each buying utility could have produced power itself at a lower cost than the purchase price.

Regulating cross-country reciprocal dealing will be difficult. In the example above, regulators must protect the interests of captive customers in Virginia, captive customers in California, competition in Virginia and competition in California. No current regulatory law was enacted with that type of transaction in mind. No regulatory structure currently exists to ensure protection of all the interests.

The most reliable solution to reciprocal dealing may be the same as the solution to self-dealing: State X bans Utility X from purchasing from another utility, where the second utility has purchased, or is purchasing, from an affiliate of Utility X.

2. Grant Transmission Access Rights to the Most Efficient Deals, Subject to Transition Rules to Protect the Investment of the Native Load Customer

General Principle: Utilities who own or control "bottleneck" or "essential" transmission facilities must share them with competitors on a nondiscriminatory basis. Congress needs to give FERC authority to order transmission access.

Reconciling "native load" with fair competition: Some utilities oppose transmission access by arguing that their native load customers have a right to preferential use of the facilities for which they have paid. This argument inflates a transitional dispute into a permanent distortion of wholesale markets.

To the extent the native load customers have already paid for facilities, they are entitled to some type of preference. But that preference should be no larger, and last no longer, than necessary to compensate the native load for costs incurred. Existing capacity will not last forever. Over the long term, all prospective users should have an equal right to use all facilities, provided they pay their fair share. To avoid perpetuating the native load preference, everyone must have an equal right to "pay for" whatever they need to compete evenhandedly in bulk power markets. This principle means that owners of monopoly transmission facilities must take into account the needs of non-native load ratepayers.

During the transition period, native load customers of the transmission monopolist have no legitimate expectation of monopoly compensation. Nor do these customers have a right to assign the incremental cost of all transmission expansions to transmission customers. On an integrated network, all facilities benefit all users. Therefore, all customers should share in the costs of all facilities. To force newcomers alone to bear the cost of new facilities is to create a monopolist's distinction, which could not be sustained in a competitive market.

Expedited litigation of transmission disputes: Even after FERC obtains clear authority to order transmission, there cannot be fair competition without expedited procedures to resolve transmission disputes. Protracted litigation dries up investment funds and simply rewards the entrenched utility with the cash flow to wait out the controversy.

3. Ensure Equal Access to Other Essential Resources

To ensure that competition is fair, there must be equal access for all suppliers to key inputs to power production. These inputs include not only transmission access, but emissions allowances, financing, key fuel supplies and construction services.

4. Limit Mergers and Acquisitions to Least Cost, Most Pro-Competitive Proposals

Merging entities typically contend that power supply and other coordination benefits will flow from a merger. They rarely compare the merger costs -- which generally include substantial acquisition premiums -- to other means of obtaining the same benefits. This myopia can lead to a bias in favor of mergers, and against other means of achieving consumer benefits. Consequently, merger proponents should be required to demonstrate that this combination is the least cost means of obtaining the benefits claimed. They also should demonstrate that there is no more pro-competitive means of achieving those benefits.

These standards should apply regardless of the corporate form used. As discussed previously, current law is confusing and conflicting on which corporate forms trigger which statutes and which standards. There should be no regulatory distinction between mergers or acquisitions through subsidiaries, divisions or limited partnerships. Each type of corporate form should be subject to precisely the same requirements.

5. Rationalize State and Federal Jurisdiction

There are good reasons to preserve state regulatory authority. State regulators have better knowledge of their local utilities than does FERC. State regulators are also better able to manage the local political environment to obtain the rules and statutes they need than is FERC. On the other hand, federal regulation has an advantage over state regulation in that it more objectively seeks out efficient solutions when provincial state goals are in conflict. The following solution tries to steer a consistent path through these principles.

In General: FERC's responsibility is to create competitive conditions in wholesale markets. Thus FERC sets industry guidelines for transmission and power pooling, and reviews specific transmission tariffs. The state's responsibility is to ensure that local distribution companies act prudently in buying from these markets. Thus states regulate utility purchases at wholesale. All transactions would be judged once: by the state regulating the purchasing utility. Assuming there is a working market (which there would be if FERC has carried out its responsibilities properly), there is no need to regulate the seller's rate, except in the situation described below.

The assumption that markets will be competitive is a large one. There will be situations where the purchase is the least cost purchase for the utility, but the price still is too high in the state's view. In those situations, the state can initiate a FERC proceeding concerning the justness and reasonableness of the seller's rate. Rather than having duplicative proceedings as we do now (FERC judge's the seller's side of the transaction and then the state judges the buyer's side), there is FERC review only when the state views the price as too high. FERC review in this situation is logical because the likely reason for the excess rate is a flaw in the market, which FERC is best able to correct.

Mississippi Power & Light Situations: States should have the right to declare that a subsidiary, after a transition period, is an autonomous actor for purposes of future power supply planning. If the utility subsidiary then is free to buy from off-system sources (or build its own generation), we would have eliminated the factual predicate for federal preemption under the Federal Power Act, i.e., that a FERC-approved system agreement precludes the utility subsidiary from acting on its own. Once it is treated as autonomous, the utility subsidiary would be subject to the same state-oriented treatment as for all other utilities, as set forth above.

6. Require Least cost Planning at FERC

In any wholesale rate proceeding affecting more than one state, FERC may not determine that a sales price was just and reasonable except according to a least cost planning process which assures that the option is the least cost option.

7. Restrict FERC Departures From Cost-Based Pricing in Wholesale Power and Transmission Transactions

Deviation from wholesale pricing based on prudent cost should be permitted only upon (1) a precise demonstration that there is vigorously competitive wholesale market which reliably generates alternatives to the product whose price is at issue, and (2) creation of review process which revisits the market inquiry each year to ensure that any market power remains mitigated.

8. Limit Investment by Utilities in Nonutility Enterprises

We should restrict such investment by (1) identifying types of investment (e.g., "black lung funds" standard now applied to decommissioning funds under IRS rules); (2) requiring advance approval and annual reviews; (3) limiting amounts invested.

9. Confirm the Legal Standing of Retail Customers to Challenge Agency Decisions Adverse to Wholesale Competition

In two recent cases, utilities have challenged the legal standing of retail ratepayers to assert an interest in wholesale competition and in corporate restructuring. These challenges are disturbing. If a captive retail ratepayer does not have a direct, economic interest in fully competitive markets, who does? Congress, within the limits of its constitutional authority, must make clear that the beneficiary -- or victim -- of electric utility practices and utility regulation is the consumer.

B. Methods for Harnessing the Forces of Competition

1. Prohibit Utilities From Expanding From Their Base as Retail and Transmission Monopolists Until Congress Verifies Their Inability to Compete Unfairly

Existing utilities are not new entrants in wholesale bulk power markets. They are existing players, protected by monopolies over distribution or transmission, hoping to expand their influence. We do not have regulatory tools which reliably can prevent abuse by one entity with two personalities -- a monopolist and a competitor. We cannot authorize monopoly utility expansion, and then hope those tools develop. Thus far most utilities have not been willing to participate in serious deliberations over regulatory protections. When they do, this question will be worth reviewing.

2. Consider A Carefully Targeted Adjustment to the "Integration" Requirement of the Act

Some "true independents" make a reasonable argument that PUHCA unnecessarily discourages certain corporate structures that could lead to least cost electricity production. Specifically, they argue that lenders insist that each power project be placed in a separate subsidiary.

These arguments are not consistent with reality today. Many companies, such as PacifiCorp and UtiliCorp, do business over large territories without setting up separate subsidiaries. If the true independents' arguments are eventually shown to have factual support, Congress should consider the necessary adjustments to PUHCA. Before doing so, however, Congress must learn more about the financing process, to assure that the subsidiary form for true independents is both necessary and efficient.

This relaxation of PUHCA should be done narrowly, however. True independents do not need, and should not have, complete exemption from all ongoing financial review, however. Consumers, as well as the entire local economy served by a true independent, has a strong interest in the short-term and long-term financial viability of electric producers. PUHCA assures such viability. Moreover, pre-acquisition review for anticompetitive impacts must remain intact. Over time, some independents may, through acquisitions, obtain market power over generation in certain regions, even though they lack distribution or transmission monopolies.

3. Require Other Entities Seeking Entry Into Wholesale Markets to Demonstrate, In Advance, Their Permanent Inability to Obtain or Exercise Market Influence

The entities seeking entry into wholesale markets range from small companies engaged exclusively in wholesale generation, to multinational construction services firms like Westinghouse and Bechtel. Each type of entity has features that offer benefits and risks to competition and the consumer. Congress must guarantee a "fitness check" at the front door, to ensure that the entrant has no anticompetitive potential and, if it does, to condition that entry to ensure that potential is never used.

CONCLUSION

Title XV is the most dramatic weakening of electric utility regulation since the 1920s. The bill authorizes entry to everyone, small and large, with and without market power, and simultaneously removes crucial protections.

I appreciate this opportunity to present my views, and again congratulate the Chairman and this Committee for initiating this debate. I would be pleased to answer any questions from Members of the Committee.

APPENDIX A

APPENDIX A

CONSUMERS POWER AND ITS UTILITY AFFILIATES

Michigan provides a laboratory of what may happen if the protections of the Public Utility Regulatory Policies Act of 1978 (PUHCA) are removed. The Act provided a window of opportunity for wholesale generators by providing, among other things, that PUHCA would not apply to a wholesale generator deemed to be a "qualifying facility" under PURPA. The implementing regulations provided that utilities could not own more than 50% of a qualifying facility.

Consumers Power Company is a combination electric and gas utility serving 67 of the 68 Lower Peninsula counties in the state. A few years ago, it restructured so that it is now wholly owned by a parent holding company, CMS Energy. Consumers' activity over the past few years comprises a series of attempts to avoid regulation, to draw off billions of dollars of assets from a public utility and use this money for non-utility purposes, and to enhance its monopoly power. The following events have taken place:

1. In the early 1980s, Consumers Power failed to obtain Nuclear Regulatory Commission operating license approval for the Midland Nuclear Plant, after Consumers had invested over $4 billion. Finding itself in financial jeopardy, Consumers sought and received emergency rate relief from the Michigan Public Service Commission (MPSC). As a condition of this relief, Consumers subjected itself to future regulatory controls over the use of any proceeds from the sale of the failed plant's assets.
2. Consumers Power Company passed up the opportunity to convert its abandoned Midland Nuclear Facility to a gas fired utility powerplant and instead transferred that opportunity to the MCV Limited Partnership in which it held a 50% ownership. [1]
3. Through a series of complicated transactions, the utility transferred the Midland assets to the Midland Cogeneration Venture, which the utility had established. The assets were then used to construct a gas-fired plant

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[1] When the nuclear plant failed, Consumers Power examined several options, including converting the facility to gas fired generation. See Consumers Power Company, Midland Options Study (April, 1986). In August of 1986 Consumers indicated it planned a capacity addition which was the Midland project's conversion to a gas turbine, combined cycle facility, construction of which was contingent upon obtaining relief from the MPSC. See Consumers' August 15, 1986 avoided cost filing with MPSC.

with power to be sold back to Consumers Power at PURPA rates rather than rates based on cost. In exchange, MCV gave Consumers Power approximately $1.5 billion in notes, which were then indirectly transferred to the control of CMS Energy Corporation. In exchange, CMS Energy provided a debenture, which could only be paid from CMS Energy assets, which payment in turn depends upon the profitability of CMS Energy.

4. The net result is that the Midland Cogeneration Venture is charging Consumers Power more for the electricity than its cost and that Consumers Power is stripping itself of approximately $1.5 billion in assets, which, with interest, currently total approximately $2 billion.

5. Consumers Power Company had been negotiating power purchase agreements with independents on a first-come, first-served basis and had been contracting at an administratively determined avoided cost.

6. Consumers Power Company entered into a wholesale purchase arrangement with the MCV for 1240 MW, moving that purchase ahead of other sellers who had been negotiating for two or three years for contracts.

4. Consumers Power Company refused to sign contracts with other wholesale generators/qualifying facilities despite the fact that such contracts had been fully negotiated, with any of these other wholesale sellers, competitors of MCV, unless they promised to support the MCV contract in the regulatory approval process.[2]

5. Now, three years later, and after extensive hearing before the Michigan Public Service Commission which resulted in an order from the MPSC that Consumers execute contracts with other independent wholesale generator/qualifying facilities in addition to the MCV,

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[2] This refusal to deal with non-affiliate wholesale generators goes back to 1987. See Amended Application and Complaint of Viking Energy of Newaygo et al. and Indeck Energy Services of Otsego, Inc. to the Michigan Public Service Commission; testimony of Viking, Indeck and Cogentrix of Michigan, Inc. in case U-8871. Indeed, Consumers knew such a requirement would disrupt the contracts which had been fully negotiated already. See Testimony of Charles Waits, Consumers Power Company witness in MPSC case U-8871 (concerning reasons for adding provisions to power purchase contracts offered to Cogentrix, Viking, and Indeck).

Consumers continues to refuse to sign up this competitive capacity.[3]

The competition in Michigan had been keen up until the time Consumers and its MCV project came on the scene. Now there is no competition.

The Michigan experience indicates that the competition offered by utilities and utility affiliates will not be "fair" competition, as explained below.

1. In order to guarantee the steam host for the MCV project, Consumers Power Company guaranteed the delivery of backup steam and electricity to the Dow Chemical Company. In other words, a Consumers guarantee to the steam host was what it took to make the MCV a reality. Of course the guarantee took a large energy user off the utility system, to the detriment of the remaining ratepayers. What was the motivation? Consumers gets one half of the profits from the MCV -- unregulated profits.[4]

2. Consumers Power Company is the gas purchase agent for the MCV. There is documented proof that Consumers contracted with then suppliers for natural gas purchases, and obtained two different price structures for the purchases. The lower price structure was for gas delivered to the MCV, with the higher price structure used for the gas purchased by Consumers itself for system gas supply. What other competitor can use the purchasing power of a regulated monopoly to drive its fuel prices down?[5]

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[3] *See* Viking Verified Application for Rehearing, July 21, 1989; Letters to Jeff Freeman of Cogentrix from David A. Mikelonis and Denise Sturdy attached to Request for Rehearing by Cogentrix, July 21, 1989; Opinion and Order issued December 21, 1989 in MPSC Case No. U-8871 *et al*; *Jackson Energy, Inc. et al v. Consumers Power Company*, Ingham County Circuit Court Case No. 90-66163-AW.

[4] *See* Recitation of "Whereas" clause in the backup agreement between Consumers and Dow dated June 9, 1988; *see also* 10.27 of Form S-1 Registration Statement for Midland Cogeneration Venture Limited Partnership filed with SEC November 23, 1990.

[5] *See* National Energy Board (Canada); Reasons for Decision, Canterra Energy Ltd., Norcen Energy Resources Limited, Poco Petroleums Ltd., Shell Canada Limited, Vector Energy Inc., and Western Gas Marketing Limited; Case GH-8-88 Gas Export, June 1989, pages 18, 20, 26; MPSC, May 3, 1990

3. The gas division of Consumers Power Company created a special gas transportation rate just for the MCV, charging it 11 cents/mcf for transportation rather than the 23 cents/mcf that it would have paid under existing tariffs. [6]

4. The sale of excess power from the MCV has been facilitated by Consumers Power Company agreeing to "purchase and resale" contracts with Ontario Hydro and Centurion. In essence, the MCV power is wheeled through the Consumers Power Company and the Detroit Edison systems. Since under this artificial purchase/resale transaction the wheeling is for Consumers Power Company's own electricity, it is done pursuant to the inter-utility interconnection agreements between Consumers and Detroit Edison. This wheeling right is unavailable to any other qualifying facility in the Consumers Power Company service territory simply because Consumers Power Company will not buy from them, much less resell on their behalf. [7]

5. Consumers has agreed with MCV to enter into transmission service agreements with other utilities, and has agreed to assist in making arrangements for deliveries to purchasing utilities not having a direct connection with Consumers. See Feasibility Report on the MCV, Stone & Webster, August 1990, page B-45.

Order in U-9173 (the record indicates that certain beneficial aspects of MCV's gas purchase contracts were likely obtained at the expense of Consumers' sales customers (slip op., p. 25); [also,] there appears to be sufficient evidence in the record to support Mr. Miller's assertion that, particularly in later years, the pricing provisions negotiated on behalf of the MCV may prove superior to those received by Consumer).

[6] See $500,000,000 Revolving Credit and Letter of Credit Facility, deposition exhibit 409; page 2 of Section V.E.; and Feasibility Report on the Midland Cogeneration Venture Facility, August 1990, Stone & Webster Management Consultants, Inc., page B-53.

[7] Consumers has granted transmission access to MCV to sell power to Toledo Edison Company/Centerior Energy Corp. and Ontario Hydro, even "loaning" the CPCo rights to wheeling through Detroit Edison to MCV on a "purchase/resale" arrangement. See S-1 Registration Statement, page 46; Feasibility Report on the MCV, Stone & Webster, August 1990, page B-16 and B-34.

6. The MCV asked Consumers what transmission capacity was available to Public Service of Indiana, stating it was considering bidding to deliver power to PSI. Consumers gave two responses. First, it indicated that if the capacity to PSI was insufficient for MCV's needs MCV should consider a "displacement" transaction in which MCV would contract with PSI for the delivery of power, and Consumers would contract with PSI for the delivery of PSI power to Consumers, and the two transactions could be netted out with MCV electrons actually delivered to Consumers. [6] Second, within six months, Consumers Power Company sought regulatory approval for a new utility transmission line to PSI. It is reasonable to assume that this was for the purpose of facilitating MCV I and MCV II in their efforts to sell power to PSI. Meanwhile, the Consumers Power Company ratepayers will pay the initial costs of the line.

The entire MCV scenario is being replayed by Consumers Power Company in a sequel named "Palisades". CMS Energy, with its partners Bechtel and Westinghouse, is seeking regulatory approval for the first nuclear "independent power producer" (IPP), the Palisades Generating Company.

This matter began with Consumers Power Company selling its Palisades Nuclear Plant to the Palisades Generating Company composed of itself, Bechtel, and Westinghouse. Along with the plant, it sold related transmission lines, lines which had been constructed pursuant to a utility's rights of condemnation. As part of the sale Consumers Power Company entered into a power purchase contract for the repurchase of all the plant's energy for 15 years.

There was no competition in this arrangement:

1. At the time the Palisades deal was entered into over 1800 MW of qualifying facility power (over and above the MCV power) was being offered to Consumers by the projects that had been working for years for contracts, all at prices below the rates in the Palisades power purchase agreement.

2. Even though under federal law (PURPA) these qualifying facilities were entitled to power purchase agreements ahead of any non-qualifying IPP, these contract offers were summarily rejected by Consumers.

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[6] See January 6, 1990 MCV letter to CPCo; April 10, 1990 letter CPCo to MCV suggesting a "displacement" transaction.

3. Some superficial bargaining with the qualifying facilities did take place, in which Consumer Power Company insisted on 30 to 35 year contracts, penalty clauses for early termination, and parental guarantees. Yet the 15 year contract it was negotiating and executed with the Palisades project had none of these.

The abuses of the MCV project may repeat themselves in MCV II. MCV II is a similarly constituted consortium to build 2000 MW generation for sale throughout the Midwest. The MCV II will be anticompetitive for the following reasons:

a. The natural gas pipeline to MCV I was oversized in anticipation of this future expansion, thus the MCV II will have no expense for this large capital expense, while competitors would;

b. Consumers likely will continue to be the agent for gas purchases, and will use market power to obtain favorable prices;

c. Consumers likely will continue to search out "purchase and resale" opportunities to give to MCV II.

The MSPC has documented a steady deterioration of the reliability of the Consumers Power Company System over the last decade. Yet when the "proceeds" from the transfer of assets to MCV came to Consumers Power Company, they were immediately passed up to the parent holding company, CMS Energy. Only quick action by the Michigan Attorney General based upon the original conditions set by the MPSC for financial bailout monies prevented this milking of the operating company. More than $1 billion is now in limbo while the courts decide whether it must be used by Consumers to benefit its ratepayers or can go to CMS Energy to benefit its shareholders. [*]

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[*] For evidence that insufficient funds may cause decreased level of service, see Consumer Power 10-Q for months of July, August, and September 1990, page 14, paragraph 8. For evidence that the cost of these transactions to Consumer Power are well in excess of cost of service if this was a CPCo project, see Barrons article of October 16, 1989 by David W. Tice calculating a cost of nearly $1900/KW for the MCV; Consumers responsive letter to the Editor clearing it was only $1440/KW; and October 1990 CPCo Integrated Resource Planning Report of Consumers, which projects an anticipated cost of $984/KW for natural gas combined cycle project.

The CHAIRMAN. Next, we have Sherwood Smith.

Mr. Smith.

STATEMENT OF SHERWOOD H. SMITH, JR. CHAIRMAN AND PRESIDENT, CAROLINA POWER & LIGHT CO.

Mr. SMITH. Thank you, Mr. Chairman. I am Sherwood H. Smith, Jr., and I am here for Carolina Power & Light Company, and for the Electric Reliability Coalition, which is a group of 44 electric utilities producing well over a third of all the power produced by investor-owned utilities.

Many other companies have also expressed support for our position. We are not, I should say, a just say nay or just say no group. Quite the contrary. We have a mission and that mission says, yes. It says, we will continue to provide the best electric generating transmission and delivery system. And to provide the public the most secure and reliable economic supply of electricity.

I have pre-filed extensive testimony, which I also ask be included in the record.

The CHAIRMAN. It will be and I have read it.

[Laughter.]

Mr. SMITH. We plan a constructive role before this body in the debate over comprehensive energy legislation. Senate bill 341, we believe, has very much to commend it. There are important positions in there dealing with the additional production of gas and oil by the United States, dealing with energy efficiency and conservation and CAFE standards, dealing with whether or not we will be able to consider the nuclear power option in this country.

Unfortunately, and regrettably, we do not believe title XV falls in that category and we must vigorously oppose title XV, which would create, what I consider to be loopholes in the Public Utility Holding Company Act that would allow some holding companies to create what would be called, "exempt wholesale generators" or EWG's, financed, primarily by debt.

And as many supporters and commentators on this legislation have said, it is simply impossible in the real world to divorce this issue from the subject of transmission access, mandatory wheeling, weakened reliability, stranded investment, higher rates to residential and small commercial customers.

Since I last appeared before the committee in 1989, it has become even clearer to me this legislation is unwise and unnecessary. The North American Electric Reliability Council's most recent annual report says, "Electric utilities have adequate plans for the 1990 to 1999 period, to provide reliable electric service to their customers."

Electric capacity margins, nationally, are now expected to increase during this decade. And the most recent forecast by the North American Electric Reliability Council shows reserves in the period of 1998 much larger than the previous forecast that appeared at the end of 1989.

We think it should be noted that in this country, we have the finest electric system in the world and it operates at a very low cost and with a high degree of reliability. In fact, the real price of electricity has been declining over recent years in many areas.

Why then, create loopholes in a cornerstone of the legal basis of this system and encourage the control of electric generation assets by unregulated holding companies through EWG's? Why discard the fundamental principles of public disclosure and regulated utility ownership? Why approve an under-capitalized pyramidal ownership scheme like that which did cause abuses prior to 1935?

Why abandon two of the cardinal principles of the current regulatory system, namely, full disclosure of electric utility costs and profits, and protection of the consumer from the financial abuses under the cover of a holding company structure?

Supporters of EWG's may argue that they will only provide optional "sources of power." But we believe that in the real world and in many situations, the State regulatory process may not account for the hidden costs of EWG power, both short term and long term, over the life of projects.

These costs are very real and they include the costs to the utility of failure of an EWG not to come on line when the power is needed. The costs to the utilities of increased utility financing charges, as EWG debt, is imputed to the utilities.

Increased costs, associated with EWG power that is not readily dispatchable or which results in excessive dependency on a given fuel and the cost of potential litigation to compel performance of supply contracts at critical times. Despite the likelihood of these higher costs to utilities and to their customers, a utility, as a practical matter, if this legislation is enacted, may find itself compelled to buy power from the EWG's. We do not see this as a benign, voluntary option at all. If so, we would have no reason to be here in vigorous opposition to it.

Deregulation and these loopholes, simply in the name of "competition" would produce many problems. Title XV would create a system that is neither fish nor fowl. It would not relieve electric utilities of their regulated status or their obligation to serve the public. Nor would it create a fair, competitive free market at the generation level.

There is not enough time allotted to the witnesses at this setting to discuss wheeling and higher costs for residential customers in great detail. But I assure you, that is a problem about which we are tremendously concerned.

The CHAIRMAN. I hope you heard me loud and clear in my opposition to wheeling. I know you think it might come on other than through this legislation. But I just want to reiterate that in case anybody has any doubt about it, I oppose wheeling and I will not allow it to come in as part of this legislation. And I hope you understand that.

Mr. SMITH. I certainly do, Senator, and I appreciate your restatement of that.

The CHAIRMAN. And by the way, Mr. Hempling, we have some studies which we would be glad to put in the record which show that there is plenty of competition—plenty of access right now without wheeling. We will put that study in the record * and make it available to you.

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* The study appears at the end of the hearing on page 410.

Mr. SMITH. We believe that some of the experience with other deregulated industries should raise an alarm, especially as is true of the highly leveraged thrift industry where deregulation is disastrous. There are many differences between the savings and loan situation and our situation, but there are some very, very close parallels. And the highly leveraged aspect is an excellent parallel, and we think the potential dangers are there.

There are problems with airlines and there are certainly problems with health care. We think that our country's need for an abundant, reasonably priced, reliable supply of electricity should not in effect become hostage in part to increased dependence on highly leveraged third-party generating facilities, many of which will use solely natural gas, that are owned by unregulated holding companies, companies whose cost of service and profits will be undisclosed and which will operate with no obligation to serve the public.

We think that title XV is a regulatory experiment which in effect would be a leap into the dark. Of all industries, because of the capital intensity, complex system of reliability, and the public's need to have continuous, ever ready service on demand, the electric utility industry should not be so drastically changed especially when there is no crisis, as pointed out by all who have studied the situation.

So in conclusion we would like to say let us look at what this debate is all about. As we see it, it is not about whether PUHCA should be amended to ensure an adequate supply of electricity. Reserve margins are adequate and have been increasing. It is not about lowering the price of electricity, certainly not to the residential customers, or increasing reliability. It is not about increasing industrial competitiveness in this country or providing more jobs for the economy.

It is about, very simply, one question. And that question could be summed up in one word, and that word is money. Should we extend leverage financing, which in some cases have been called junk bonds, to a group of nonregulated companies with absolutely no public service duty simply to enable them to make, as they have under PURPA, what I would call a fast buck at the expense of electric consumers in this country, and then have the ability to leave the consumers high and dry with no service from that project, or to charge exorbitant prices later on.

Because what happens at the end of these contracts if the project is built by utility, the power from that project will be charged on the basis of the depreciated cost of service coming from that plant, and the public will get the benefit of the depreciation which it paid in its rates. But if the public is dependent upon an EWG, the EWG has no public service operation. The State commission does not regulate its rates, and it will charge what will then be called, euphemistically, market prices which will, in my opinion, then be exorbitant and much, much higher than the prices from the project if it had been owned and built by a regulated utility.

I hope that this legislation will not be enacted.

Thank you.

The CHAIRMAN. Thank you, Mr. Smith.

[The prepared statement of Mr. Smith follows:]

March 14, 1990

Before the Senate Committee on Energy and Natural Resources

Statement of Sherwood H. Smith, Jr.

Chairman and President,
Carolina Power & Light Company
and
Chairman, Electric Reliability Coalition

My name is Sherwood H. Smith, Jr. I am appearing today both on behalf of Carolina Power & Light Company and in my capacity as Chairman of the Electric Reliability Coalition (ERC). The ERC is a group of regulated investor-owned electric utilities, formed in mid-1989 and currently numbering 44 member companies. A list of our members is attached. We estimate that ERC members produce well over a third of all power sold by investor-owned utilities in the United States. In addition, many other electric utility companies have expressed support for our position.

ERC's mission is to continue to provide the best electric generating, transmitting and delivery system and the most secure, reliable and economic supply of electricity to the nation's present and future customers. Our goal is to preserve the vertically integrated electric utility industry, regulated in the public interest and preserving the system of voluntary transmission services, which together have proven so effective, reliable and in consumers' interest.

To be fully able to carry out our public service responsibilities, ERC must oppose Title XV of the National Energy

Security Act. In the name of "reform," Title XV would encourage the establishment of holding companies to own and control "Exempt Wholesale Generators," free from regulation by the Securities and Exchange Commission. The unregulated status of these holding companies and their EWG subsidiaries would contrast sharply with the public interest restrictions on and regulation of ownership, financing and operation of retail electric utilities under the 1935 Act. New "EWGs" would be built with levels of debt far exceeding those for regulated electric utilities and public utility holding companies. The ERC strongly believes that deregulation of these holding company structures will significantly increase the cost and reduce the reliability of electric service for consumers.

My own company, Carolina Power & Light Company, is an investor-owned electric utility serving about 960,000 customers in a 30,000-square-mile service territory in North and South Carolina. Our system has a generating capacity of about 9,700 megawatts. We use coal and nuclear energy as our principal sources of fuel, operating 19 coal-fired generating units and four nuclear units, as well as about 40 smaller hydroelectric, combustion turbine, and waste heat units. Our company has been a pioneer in the development and use of nuclear power having built the first nuclear units built in both North and South Carolina.

In my work, I have had the opportunity of serving on a number of industry boards, including Director and past Chairman of the Edison Electric Institute (EEI); the North American

Electric Reliability Council (NERC); the Southeastern Electric Reliability Council (SERC) of which I have been Chairman; as a Director of the Institute of Nuclear Power Operations (INPO); and as a Director and past Chairman of the American Nuclear Energy Council (ANEC). I was a principal witness and industry coordinator during the lengthy hearings on the Public Utility Regulatory Policy Act (PURPA) in 1977 and 1978. Then, in 1989 I testified before this Committee on then-pending similar proposals for amendment of the Holding Company Act. My experience, I believe, has provided me with a very clear understanding of the issues now before the Committee.

Several important developments have occurred since I last appeared before the Committee. First and perhaps most important, it has become even clearer to me that this legislation is not only unwise, but unnecessary. Although there are many flaws with the study of the PUHCA issue prepared for the President's Economic Policy Council last fall as part of the National Energy Strategy, I concur wholeheartedly with the study's conclusion that there is no looming electric supply crisis which only EWGs can solve. According to the North American Electric Reliability Council's most recent assessment:

> Electric utilities have adequate plans for the 1990-1999 period to provide reliable electric service to their customers.

(North American Electric Reliability Council, 1990 Reliability Assessment: The Future of Bulk Electric System Reliability in North America 1990-1999, at 4.) NERC confirms, at page 4, that utilities are planning to obtain the required supplies from a variety of sources, including "enhanced performance of existing units, additional utility generators, additional non-utility generators, and the purchase of electricity from neighboring utilities." Id. at 5. Whereas in its 1989 assessment, NERC estimated that total U.S. capacity margins would be 17.6 percent in 1998, the 1990 assessment projects a higher reserve margin of 18.5 percent in 1998. (NERC, 1989 Electricity Supply & Demand For 1989-1998, at Table 8; NERC 1990 Electricity Supply & Demand For 1990-1999, at Table 8.)

Even the limited and localized potential electric supply constraints that appeared in the NERC study a year ago to be potential problems have essentially vanished. NERC's 1990 reliability assessment, at Table 8, projects that the North East Power Pool (NEPOOL) will have a capacity margin of 16.7 percent in 1998, double the margin projected only a year earlier. In short, it is clear that the investor-owned electric utility industry -- including my own company -- is committed to meeting future demand by: (1) building new generation (base load and peaking) as needed; (2) efficiency, conservation and load management; (3) inter-company purchases of electricity; and (4) utility arrangements with co-generation and other sources when it is in the long-run best interests of utilities and their customers to do so.

These findings confirm that the long standing, proven system of cost-of-service regulation works well in spite of various problems from time to time. This makes possible the current high degree of integration and cooperation within and among electric utilities, in terms of supply and reliability. They also confirm that third-party ("non-utility") generation already plays an important role in the electricity supply picture, accounting for a significant part of newly completed generating capacity. How, then, could it be necessary to partially deregulate the industry in order to encourage formation of unregulated holding companies to own and control generation assets? Restructuring the industry would not offer any significant benefits to consumers. Under restructuring regulated utilities would certainly continue to be required to meet their obligation to provide reliable electric service, but very likely at increased, not reduced, overall cost to the consumer.

Some historical perspective is in order. The origins of today's modern economic regulatory system can be traced to the Federal Power Act of 1935, to PUHCA, and to various state laws of similar vintage. The Federal Power Act established a national policy to assure "an abundant supply of electricity throughout the United States" with economy and regard for the environment. A regulatory system was developed which eliminated uneconomic and wasteful duplication of facilities and channeled competition into an orderly process of franchised utilities responsible for providing service to all within certain geographic areas and subject to regulation of pricing based upon reasonable recovery of the costs of such service. At the same time, the Holding Company Act established fundamental principles of utility ownership, control and operation designed to protect both consumers and investors from the financial consequences of undercapitalized, pyramidal ownership like that which characterized the unregulated system prior to 1935. Two of the cardinal principles of PUHCA are full disclosure of electric utility costs and profits and protection of the consumer from financial abuses under cover of a holding company structure.

There followed a period of remarkable growth in electric output and a sharp decline in the real price of electricity. In the 1970s this price decline was interrupted by a combination of many factors such as the OPEC oil embargo, inflation, recession, environmental rules, the expansion of nuclear safety regulation, changes in the country's rate of economic growth, etc. At the same time, electric utilities in some jurisdictions were unable to recover billions of dollars of capital investment, when new nuclear capacity costs rose to unexpectedly high levels, as load growth diminished and some capacity was excess. Nevertheless, the industry and the nation emerged successfully from these traumas, and we continue to have adequate supplies of electric power in this country at reasonable costs. In fact, the real price of electricity in many places has been declining over recent years and some regions have large reserve margins.

Thus, I believe that by any standard, over many years, the investor-owned electric utility industry has done an outstanding job in meeting the needs of electric consumers in this country by providing them with adequate, reliable and reasonably priced electricity. This has been accomplished by a large and incredibly complex system of vertically integrated utilities with generation, transmission and distribution facilities interconnected throughout the country at strategic locations for reliability and economy transactions. Service to consumers and our entire economy has benefited enormously from this fully integrated and regulated system of generation, transmission and distribution. A fully integrated system can produce economies and reliabilities to customers that cannot be guaranteed in other forms of industry structure.

Although electric utilities are frequently described as franchised, natural monopolies, they are subject to a number of competitive forces. Other forms of energy, such as gas, oil, coal, have competed for many years with electricity. Today, as technology advances rapidly, new end-use devices may replace or reduce the use of electricity in many applications, as may self-generation alternatives for some customers. Further, public power has been a substantial competitor in many areas with the investor-owned industry, and some public power distribution systems have been able to shift sources of bulk power supply in a competitive context.

Under PURPA, too, there have been competitive new entrants into the generation field, and many of them were subsidized by ratepayers of utilities forced to buy power which they did not need at prices higher than their own generation cost. There have been many abuses under PURPA, which should give rise to even further caution about another similar action as proposed under Title XV.

In the constructing, purchasing, and other practices of utilities the benefits of competitive pricing for goods and services can often be obtained and passed on to consumers. In this regard, fuel clause review and the availability of other regulatory scrutiny serve a useful role. Also, every day in power pools and intercompany exchanges there are thousands of competitive sales and purchases of energy between utilities.

One of the main problems with proposals like those in Title XV is that incomplete deregulation of some of the industry will lead to a system that is neither "fish nor fowl." Title XV would not create a fair competitive free market, but it would disrupt our system of traditional public utilities appropriately regulated in the public interest. The potential for gross inequities under such a new, untried system of partial deregulation is very great.

The nation's large, complex and integrated electric utility systems have a legal obligation under the laws of the states in which they operate to provide adequate, reliable and continuous service to all present and future customers within a geographic area. The states, acting through public service commissions, are responsible for ensuring that utilities meet these obligations. State commissions usually have a final say as to when, where and under what conditions electric utility generating facilities may be built and operated to serve the public and how electric service will be priced with "reasonable" rates. This is often referred to as the "regulatory compact."

The type of "competition" advocated by some who want to set up holding companies to own and control wholesale generation would be far from the economists' model. Utilities would still be subject to the franchise duty to serve the public, but would have the burden of being required to buy a competitor's product and deliver it to customers in lieu of their own product. EWGs and their parent holding companies would have no franchise duty to supply the public. No one can predict exactly how deregulation and this new form of unequal competition or partial deregulation would -- or would not -- work out.

The experience in other deregulated industries, if applied to electric utilities, is more cautionary than encouraging. The electric industry's structure and product/service is completely different from other industries in which deregulator experiments have been conducted, with mixed results: natural gas, telecommunications, airlines, trucking, health care. Indeed, deregulation in some industries, especially the thrift industry, has had disastrous results. Therefore, we should focus carefully and exclusively on the electric utility industry in deciding whether to take another leap into the dark waters of illusory "competition."

Public utilities, in order to meet the comprehensive obligations to provide universal, reliable, reasonably priced service to consumers, subject to public regulation, must be able to plan for and control all sources of new capacity; to integrate them into large complex systems; and then to rely on their availability over decades of service. In other words, since utilities have the obligation to serve they must, subject to regulatory control, have the management discretion and authority to determine how they will carry out those responsibilities.

To meet future electric demand and to preserve the benefits of the integrated system, it is absolutely essential that substantial equity capital continue to be encouraged to be invested in new electric generating facilities and that those facilities be constructed subject to regulatory obligations to serve the public. If equity investment by utilities in generation facilities is discouraged and eliminated on a large scale, then over time there will be the displacement of utility ownership and control of the very foundation of this complex integrated system. There would occur over time a substantial dismantling and disintegration of the vertically integrated and fully regulated system, which has evolved carefully and pragmatically over many years and served our country so well. This development, in my opinion, would substantially reduce the ability of electric utilities to meet their public service obligations on a reliable and cost-effective basis, and thus risk great harm to our nation's economy.

Some advocates of PUHCA amendment argue that there will be unforeseen benefits, just as assertedly occurred in some other deregulated industries. I take the opposite view: if we are unsure of what the outcome will be, then the prudent course of action is more careful study. To preserve reliability, reasonable costs and the public benefits of the vertically integrated system, it would be extremely unwise to seek to alter "incrementally" this very complex system in the name of "competition" or other economic theory without first investigation, evaluating and carefully determining how such changes might affect our nation's entire electric system over the long term.

It takes many years to plan and build base load generating plants and transmission lines. Large generating plants well maintained and modernized may have useful lives of 40 years or more. Decisions to build or not to build, once made, can have long-lasting impacts and repercussions on the availability, reliability and cost of electricity to the public. For example, if short-term comparisons of fuel costs and capital costs are made versus an analysis of long-term costs and trends, then seemingly expedient choices may be made today at the expenses of higher costs and unreliable service tomorrow.

To ensure that public utilities have the incentive to make needed investments in electric power production, we should improve and strengthen some aspects of the regulatory process, particularly at the state level. There are state actions, other than PUHCA amendments, which would make good sense from the standpoint of both customers and utilities. A policy initiative to encourage early regulatory review of load forecasts, generation planning, construction schedules, and costs for large projects should eliminate the possibility of destructive post-construction "prudency" reviews. These and similar measures are under discussion in many jurisdictions at the state level, where such decisions should most appropriately be made. The National Association of Regulatory Utility Commissioners (NARUC) is also considering such measures.

Let's look further at existing non-utility generation. In recent years, under PURPA, new "unregulated" suppliers of electricity have been subsidized in many cases and have built new generating facilities, which in many cases were not needed. Utilities often have been required to purchase electricity from such facilities at prices higher than the utilities' cost of generating such electricity on their own systems. One need only look at Texas and California to see situations where PURPA has produced excess capacity and higher costs. Under existing law and regulatory provisions, there are expected to be a growing number of such new "unregulated" generation facilities through the next decade, which may have the potential of producing excess capacity in some areas and pricing service from such unregulated facilities above true avoided costs. For example, NERC already projects that over one-fifth of new capacity additions in the U.S. during the next ten years will be supplied by these sources, which include both Qualifying Facilities under PURPA and independent power plants such as the Ocean States or Doswell projects.

In many cases such PURPA generating plants have been, and will be, built in "competition" with generating capacity that would otherwise be provided by the duly franchised utility serving the geographic service area. Because of PURPA there already is a real threat that utilities in some places may be effectively thwarted to a substantial degree from building new generation in their own service areas. Utilities could be precluded from building new base load coal and nuclear facilities. Federal action, as in Title XV, to encourage more of this is undesirable and would have serious adverse impacts. In the future, this could easily mean that substantial amounts of generating capacity would be owned and operated by those not under regulatory controls with no obligation to serve and with no incentive to serve except at so-called market prices which over time could be much higher than cost-based rates. In such a case, consumers would risk economic hardship from both higher costs and reduced reliability. Especially will this be true when the initial PURPA contracts expire and consumers (and regulators) are then faced with much greater, inflated market prices.

The electric utility industry under existing law and regulation already is presented with difficulties in attempting to adjust to these new "non-utility" facilities and seeking to integrate them on a basis that would reduce and moderate the adverse impacts on reliability and economics for the utilities and their customers. This assumes certain things, including: (1) that utilities will be allowed, under state regulation, to schedule the installation of such facilities to meet the utilities' load-growth requirements; (2) that the utilities will be able to control the operation of the transmission system and the dispatch of power from such facilities; (3) that strong enforceable contracts will seek to assure the continued availability and reliable operation of the generating resources (although such contracts can never provide the same assurance as utility ownership and control); (4) that electricity under the "avoided-costs formula" of PURPA will be reasonably priced to utilities; and (5) that utilities will be able to recover at least their full costs of buying such power.

The promised benefits and efficiencies of PUHCA "reform" and resulting "competition" in wholesale generation are illusory. This is apparent if we look at the principal categories of risk associated with new generating capacity, which traditionally have been shared by utility ratepayers and utility stockholders. These risks are: (1) risk that projected demand will not materialize; (2) risk that construction will take longer than planned; (3) risk that construction costs will exceed projected levels; (4) risk of operational inefficiencies; (5) risk that fuel costs will exceed the utility's projections; and (6) the overarching risk that, under post hoc prudency review or the "used and useful" doctrine, state regulators will not allow the utility to recover construction costs which it has financed. Advocates of EWGs say that, with ownership and control of new facilities by unregulated holding companies, significant risks can be shifted off purchasing utilities and on to independent power producers, equipment vendors, and fuel suppliers.

In fact, EWG advocates have publicly stated that project developers will not assume the two most significant risks, i.e., the risk that, due to unforeseen changes in load growth, newly constructed capacity may turn out to be unneeded and the risk that fuel prices may rise to unforeseen levels. The EWG industry intends to develop projects on a non-recourse, project-financed basis using 90 percent or more debt. They appear to plan to use holding company structures so as to ensure that parent companies' assets do not stand behind and assure these projects' performance. Such highly leveraged project financing by EWG's would be impossible if developers were to retain significant risks. Instead, as this Committee heard in 1989, EWG developers testify that it is entirely right that utilities should sign long-term contracts obligating themselves to pay for the new capacity, "regardless of market demand and regardless of fuel costs." (Transcript of Hearing on Amendment No. 267 to S. 406, The Competitive Wholesale Electric Generation Act of 1989, November 16, 1989, at 77, l. 2-7.)

A public utility and an EWG have fundamentally different obligations and economic incentives. A highly leveraged, project-financed EWG could be readily abandoned, either prior to completion or during operation, if its developers found the project had become uneconomic due to construction cost overruns or unforeseen operating costs. This has already happened with renewable energy projects under PURPA. On the other hand, a purchasing utility, with a legal obligation to provide electric service may not be able to tolerate business failure on the part of an EWG on which it was depending for a significant portion of its electricity requirements. Faced with the threat of project abandonment or default, the utility could come under great pressure (including pressures from regulators) to renegotiate its contract with the EWG, take over the failing project and otherwise provide additional financial resources, or be forced to provide replacement power at much higher cost than it could otherwise have done if the EWG had not precluded this opportunity initially.

States will not relieve utilities of the public obligation to serve consumers simply because they are relying on EWGs for their supplies. These utilities will remain de facto guarantors of risks purportedly assumed by project developers. Significant reallocation of risk leading to real savings for consumers appears inconsistent with the legal environment in which franchised utilities must operate.

Because of a public utility's obligation to provide electric service on demand, a utility which depends on EWG power would have to ensure against supply failures by increasing its reserve margins. Since the Committee's 1989 hearings, Standard & Poor's has prescribed just such increased reserve margins for an EWG-dependent utility to maintain its credit rating. The rating agency observed that:

> [T]here is also risk in planning on third-party generation that may never actually materialize. This vulnerability in supply planning is due to the likelihood that a significant portion, perhaps up to half of all projects actually contracted, may fall by the wayside.

Standard & Poor's, Utilities Credit Comment: Utilities' Risks in Purchasing Power 3 (March 26, 1990). Standard & Poor's requires a utility which relies on non-utility power for more than 10 percent of its requirements to establish significantly higher capacity reserve margins -- as much as 20 to 30 percent higher -- than are otherwise required for an electric utility.

NERC also has recently confirmed that:

> NUG plans and commitments are not always realized. . . . NUG owners are not immune to similar problems faced by electric utilities in getting generating units sited, permitted, constructed, tested, and on-line as scheduled. NERC 1990 Reliability Assessment at 23.

Contracting for redundant generating capacity in order to protect against some uncertain amount of EWG supply attrition is inherently inefficient. These increased reserve margins would mean higher capital costs for a utility and higher rates for consumers.

There is another source of "hidden" costs of relying on EWG power. Where a utility exceeds the aforementioned 10 percent threshold, Standard & Poor's has confirmed that it intends to assign all of the utility's long-term firm capacity payment obligations to its balance sheet as debt, thus further increasing the utility's cost of capital for financing other investments. Such costs ultimately would fall on utility ratepayers.

One very significant effect of the construction of these unregulated generating plants is likely to be the displacement of substantial amounts of utility equity investment and the substitution of new leveraged debt based upon the financial credit of the utility purchasers of power from these unregulated sources. What will be the long-term effects of this situation in which more and more electric generation in this country is dependent upon unregulated ownership financed almost solely with debt and subject to no duty of public service? In other industries, generally, the excessive uses of leveraged buyouts financed by high levels of debt have caused major problems. The failure of such other businesses, however, would not have the serious public consequences of the failure of electric generation entities. Utilities use only about 50 percent debt, and this is subject to regulatory control mindful of the importance of financial stability and meeting the obligations of serving the public.

Advocates of Title XV insist that it would merely create an "option" for utilities to buy power from these new, deregulated EWGs. Indeed, the legislation includes a provision that purports to allow electric utilities to elect not to purchase power from EWGs for up to ten years. Is this really the protective feature it appears intended to be? The answer is no.

EWGs can have an artificial competitive advantage over utility-build and other options that can result in apparently lower bid prices for EWG power, especially in the early years of project operation. This is because, by shifting most significant risk to the utility and obtaining a guaranteed capacity contract that covers all fixed costs including profits, the EWG can finance its facility with up to 90 percent (or higher) debt. The resulting lower cost of capital for the EWG will enable it to price its power substantially below the power from a utility-built alternative finance with 50 percent debt. We estimate that such an EWG probably could price electricity 5-10 percent lower than the direct cost to a utility of building and operating equivalent capacity. (The price difference between power generated by gas-fired EWGs and new coal or nuclear baseload utility plant could be even greater.)

We believe that some state regulatory processes may fail to account for the hidden costs of EWG power, both short-term and over the life of the project, in evaluating EWG offers or bids. While apparently less costly than utility-owned capacity, EWG power would impose significant indirect costs on a purchasing utility. These include the cost of increased reserve margins and redundancy in supply sources to insure against EWG failure and default, and increased costs associated with EWG power that is not readily dispatchable or which results in excessive dependency on any given fuel.

State regulation may not recognize and account for all of the indirect costs to a utility associated with reliance on purchased power. Political considerations, such as ratepayer demand for "apparently lower cost" EWG power, or environmental opposition to coal or nuclear power, may preclude the regulators from accurately evaluating the costs of EWG power. A utility may, as a practical matter, be unable to avail itself of utility provided rate-base alternatives which would be less costly over the long term.

The problem is not alleviated by the opportunity to opt out of such purchases from EWGs. State commissions have numerous ways of influencing jurisdictional utilities' decisions. To say the least, it could be unwise politically for a utility to take its commission to court to seek to enforce a federal right of election in the face of a state commission preference for increased reliance on EWG power for some reason.

Finally, I believe that Title XV could have a seriously negative effect on energy security by making our electric generating industry too dependent on natural gas-fired EWGs. According to the UWGs's own figures, of the 700 megawatts of competitively procured capacity now on line, almost 45 percent is gas-fired and only 25 percent is coal-fired. By contrast, utilities' installed capacity is 17 percent gas and 43 percent coal. The American Gas Association recently announced that the gas bubble has evaporated:

> The excess natural gas production capability (the "gas bubble") that has characterized the natural gas market since 1980 has for practical purposes disappeared. The natural gas market during a cold winter heating season is using all of the available production and supplementing those volumes with natural gas from storage and imports.

AGA, Issue Brief 1991-4 (Jan. 18, 1991). NERC has cautioned that:

> A sudden change in the fuel supply environment or additional governmental regulations could drastically limit fuel supplies to many of these [gas-fired combustion turbine or combined cycle] units. This is particularly true for NUGs, many of which have interruptible fuel supply contracts. These fuel situations can reduce electric system reliability.

NERC 1990 Reliability Assessment at 22 (emphasis added). NERC reports that:

> MAAC [Mid-Atlantic Area Council] has experienced some problems with NUGs having interruptible gas supply contracts and NUGs not being available during periods of extreme cold weather when electric demand was high and natural gas supplies were interrupted. In some cases, NUGs have dual fuel capability, but inadequate or limited fuel storage facilities raise doubts as to their availability for extended operation with alternate fuels.

Id. at 41. According to NERC, electric utilities in California experienced natural gas curtailments in November 1989 as gas was diverted to storage for the winter heating season. Id. at 41. Increased reliance on EWGs could aggravate an already potentially serious gas supply and deliverability situation. This will particularly be true if EWGs are built instead of Qualifying Facilities that would have used renewable resources, which currently make up fully one-third of all QF capacity. 1 Utility Data Institute, Inc., Directory of Selected U.S. Cogeneration, Small Power and Industrial Power Plants, Table 2, (Oct. 1989)

In conclusion, Title XV raises a fundamental public policy question: Is the nation's critical need for an abundant, reasonably priced, reliable supply of electricity over the next decade and beyond consistent with increased dependence on highly-leveraged third-party generation facilities owned by unregulated holding companies whose costs of service and profits will be undisclosed and which will operate with no obligation to serve the public? The answer clearly is No. The North American Electric Reliability Council has cautioned against such experimentation:

> [Electric] system reliability should not be compromised for short-term economic benefits. In the long run, short-sighted approaches could result in severe economic penalties to the customer and even endanger public well-being.
>
> A creeping degradation of the reliability of the electric systems must be avoided. A number of proposals that may ultimately change the way electric utilities are structured and operated are being debated by policymakers. Many of these proposals fail to address associated reliability impacts. Each of the proposals, public policies, or regulatory treatments, before implementation, needs to demonstrate its potential effects on existing and future electric system reliability. NERC 1990 Reliability Assessment at 7.

The Office of Technology Assessment (OTA) Report similarly cautions that "...the costs and benefits of competition are very uncertain... Actual experience is limited, and little analysis has been performed... The benefits of competition are speculative and difficult to quantify... It should be noted that the OTA report concludes that "...even without legislative action, the competitive segment in the electric power industry is growing... These trends are likely to continue... There is no crisis mandating immediate action by policymakers."

In short, simply invoking the name of "competition" does not make the case for placing the nation's electricity future in the hands of a lowest-bidder, unregulated electric supplier dependent upon highly leveraged generation assets with no obligation of public service. For this reason, we respectfully urge deletion of Title XV from this important legislation.

"APPENDIX A"

CAROLINA POWER & LIGHT COMPANY

CENTERIOR ENERGY CORPORATION

CENTRAL AND SOUTH WEST CORP./CENTRAL AND SOUTH WEST SERVICES, INC.

CENTRAL HUDSON GAS & ELECTRIC

CENTRAL POWER & LIGHT COMPANY

CINCINNATI GAS & ELECTRIC COMPANY

COMMONWEALTH EDISON COMPANY

DETROIT EDISON COMPANY

EL PASO ELECTRIC COMPANY

EMPIRE DISTRICT ELECTRIC COMPANY

FPL GROUP, INC.

FLORIDA POWER CORPORATION

GULF STATES UTILITIES COMPANY

HOUSTON LIGHTING & POWER COMPANY

ILLINOIS POWER COMPANY

INTERSTATE POWER COMPANY

IOWA ELECTRIC LIGHT AND POWER COMPANY

IOWA POWER, INC.

IOWA PUBLIC SERVICE COMPANY

IOWA-ILLINOIS GAS AND ELECTRIC

IPALCO ENTERPRISES, INC. (INDIANAPOLIS POWER & LIGHT COMPANY)

KANSAS CITY POWER & LIGHT

KANSAS GAS AND ELECTRIC COMPANY

MADISON GAS & ELECTRIC COMPANY

MINNESOTA POWER

NORTHERN INDIANA PUBLIC SERVICE

OKLAHOMA GAS AND ELECTRIC COMPANY

OTTER TAIL POWER COMPANY

PENNSYLVANIA POWER & LIGHT COMPANY

PHILADELPHIA ELECTRIC COMPANY

POTOMAC ELECTRIC POWER COMPANY

PUBLIC SERVICE COMPANY OF COLORADO

PUBLIC SERVICE COMPANY OF OKLAHOMA

SOUTH CAROLINA ELECTRIC & GAS COMPANY

SOUTHERN INDIANA GAS & ELECTRIC COMPANY

SOUTHWESTERN ELECTRIC POWER COMPANY

SOUTHWESTERN PUBLIC SERVICE COMPANY

TECO ENERGY, INC.

TEXAS UTILITIES COMPANY

VERMONT YANKEE NUCLEAR POWER

WEST TEXAS UTILITIES COMPANY

WISCONSIN ELECTRIC POWER COMPANY

WISCONSIN PUBLIC SERVICE CORPORATION

STATEMENT OF DON D. JORDAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, HOUSTON LIGHTING & POWER CO.

Mr. JORDAN. Thank you, Mr. Chairman. Mr. Chairman, I appreciate the opportunity to testify in opposition to amendments to the Public Utility Holding Company Act in S. 341. I know I speak form experience, because my company has more nonutility generation than any other in the country, some 4,700 megawatts, 17 percent of the total number of kilowatt hours produced by—sold by our company were produced by nonutility generation. To give you a benchmark, that is more electricity than is used in the entire city of Cincinnati, Ohio.

So I have seen firsthand how well-intentioned Federal legislation is manipulated to saddle the electric utility consumer with billions of dollars and excess cost. It is important for me to note right at the beginning that this really is a bill about money, who gets it and who pays it. It is not a bill about electric capacity, about the type of fuel to me used, or a bill about competition. It is certainly not one about consumer benefits. It is a bill about money, who gets it and who pays it.

Now, let me explain that to you. When PURPA was first passed in 1978 it was intended by Congress to promote economy, efficiency, and conservation. Today, proponents of the PUHCA amendments will cite it is proof that deregulation works. It is true that independent generation was built, but at what cost? It has not worked well, and I offer these examples to you. I cannot hope to give you these details in 6 minutes. I hope you will ask me some questions to make me prove what I say is correct.

Let me tell you about hundreds of millions of dollars. On our three largest gas-fired cogeneration contracts customers are legally obligated to pay an average of over $190 million per year more for power coming out of those units than they would have to pay if we had been allowed to build comparable gas-fired generation. And they get nothing in return for that $190 million a year. That is nearly $2 billion coming out of their pockets over a 10-year contract for nothing.

When you multiply this by the number of times it has happened across the country there are billions of dollars that electric customers in the United States have paid that they would not have had to pay.

Item number two, a PURPA loophole allows a simultaneous buy-sell arrangement under which cogenerators can theoretically sell power to us at about 6 cents a kilowatt hour and buy it back at 2 cents a kilowatt hour in a paper transaction. One cogenerator last year took 288,344,559 kilowatt hours more from us than they theoretically sold back, and we paid them $65 million to take it.

Now, this will cost our consumers about $600 million for nothing over the term of that contract. Gentlemen, does that make any sense to you at all? I know the United States Senate would not have passed legislation such as this if they had know this would happen. But no windfall can go on forever. Congress started the downslide when they repealed the Fuel Use Act in 1988 and eliminated what was almost an absolute right to these huge returns.

Now, do you not think it is interesting that shortly thereafter, this effort was started? I suggest to you that is not just a coincidence. State commissions then started to realize what was happening and tightened up on the fact that electric retail customers were being ripped off. The new contracts that are now being drawn are much tighter, and these consumer rip-offs will not be available to the same degree in the 1990's.

Now, I think you can imagine that unregulated generators do not want to see this gold mine closed. They will use every legal, legislative, and administrative strategy available to protect it. For example, I have a letter with me today from one of the buy-sell cogenerators that States we are legally bound to extend that agreement beyond the terms of the contract at a cost of another $400 million to our consumer, and the consumer gets nothing in return.

So it is clear that PUHCA amendments constitute the first step in the gold rush of the 1990's, and the gold deposits are found in the pockets of the American consumer, which is why we are here today. Senator, as the proponents of PUHCA, amendments did not come to you first. They began this process at the FERC where their efforts failed for lack of public support.

The CHAIRMAN. Mr. Jordan, you have up a good head of steam now and I hate to interrupt you, but if I could get you to summarize so we can have a few minutes for questions.

Mr. JORDAN. Okay, I will be through in 6 minutes.

They did not come to you first. They first began at FERC, where the efforts failed for lack of public support. In a very clever move, they are now asking you to do indirectly what they could not get done directly. They masked their goal behind the popular words of competition, but that is not their true goal. I do not think any of us ought to be deceived. Their motive is still the same unrestricted retail transmission access to in-users, either through the courts or through Congress, because that is where their gold mine lies.

Now, Mr. Chairman, I appreciate your determination that that will not happen, but I want my prediction to be recorded well here today. And that is that if you pass this legislation, it satisfies their first goal. And very soon, legal action will be filed on their part to attempt to force open transmission access. And if they win, residential and small commercial customers will once again pay for nothing.

You are being asked to brush aside a century of accomplishment in favor of industry restructuring. You must ask yourself why should you do it. You have been subjected to a lot of puff talk here this morning and I am sure over the last couple of months, but there are some obvious questions you must ask. I will give you my answers to those questions and, again, please make me prove it.

First, can IPP's construct comparable power plants cheaper than utilities? My answer is, absolutely not; not without cheating on design. And that perhaps is an opportunity for debate. Can they reduce the financing cost impact on the public? Absolutely not. Can they buy fuel or operate plants cheaper? Absolutely not. Do the IPP's promise to improve long-term choices of fuel requirements? Absolutely not.

Are their units more reliable or will the electric transmission system be improved? Absolutely not. Will they accept a utility rate of return on equity? Absolutely not. Ask them if they are satisfied with 12.5 percent. Do they really seek true and equal competition? Absolutely not. And will the impact of regulation on electric utility distribution companies be reduced? Again, absolutely not. Then finally, is there a ground-swell of support for such legislation other than by those who would benefit from it? And I would say, absolutely not.

The United States Senate, Mr. Chairman, is a responsible body to which citizens look for protection. Surely there must be some clear and strong reason to pass new legislation restructuring this industry. This is a consumer issue, and if their long-term interest is considered I think you will have to reject the amendments to PURPA.

Mr. Chairman, I have some additional support documents I would like to file for the record, if that is all right.

[The prepared statement of Mr. Jordan follows, the additional materials have been retained in committee files:]

U.S. SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

March 14, 1991

Testimony of Don D. Jordan

on Behalf of

Houston Lighting & Power Company

and the

Electric Reliability Coalition

Good Morning.

My name is Don Jordan. I am the Chairman and Chief Executive Officer of Houston Lighting & Power Company and a member of the Electric Reliability Coalition described to you by Mr. Smith. I appreciate the opportunity to testify in opposition to the proposed amendments to the Public Utility Holding Company Act (PUHCA) in S. 341 and to tell you of the serious dangers associated with unregulated non-utility generation. I speak from experience: there is more non-utility generation in Houston Lighting & Power Company's area than anywhere else in the country -- some 4700 megawatts of non-utility capacity in operation.

To give you some perspective, that is more than enough electricity to serve the entire city of Cincinnati. With so much non-utility generation in operation, I have seen first hand how well intentioned federal legislation is manipulated in such a way as to saddle electric consumers with billions of dollars in excessive costs.

The Public Utility Regulatory Policies Act (PURPA) of 1978 was intended by Congress to promote economy, efficiency and conservation. In reality, PURPA has had a significant adverse impact on the American consumer. Yet proponents of PUHCA amendment are using the PURPA experience as "proof" that deregulation works. PURPA has not worked, and I offer you these concrete examples of how American consumers have been harmed.

- As a result of PURPA regulations, HL&P's consumers are legally obligated to pay gas-fired cogenerators an average of over $190 million per year more for electricity than if my company had been allowed to construct comparable gas-fired capacity. Over the terms of these contracts, this will cost our consumers nearly $2 billion. This combination of legislative and regulatory requirements, which compelled us to make those contracts, were intended to benefit consumers, but produced just the opposite result. Congress tried to fix this problem through repeal of the Fuel Use Act -- but the correction came too late.

Undoubtedly billions and billions of dollars have been paid by electric consumers across the country as a result of contracts negotiated pursuant to this statutory and regulatory mistake. Who in this room would have predicted this outcome in 1978 or would have supported it if they had any idea of the effect?

- Another example; cogenerators in my company's service area are using regulatory loopholes created by PURPA to avail themselves to a contrivance known as the "simultaneous buy/sell". Under this scheme, a cogenerator is paid for generating power at a rate greater than what we charge to serve the same load. Our avoided cost payment to the cogenerator is significantly larger than the price we are allowed to charge that cogenerator for power. So, rather than self generate and sell only its excess power, the cogenerator will sell all of its power at the higher price and purchase its electricity needs from the utility at the lower rate. In effect, we send a cogenerator large sums of money for self-generating and our customers pay the cogenerator to take power from our system. One cogenerator on our system actually receives a net amount of energy of approximately 228,000 mwh annually, yet is paid in excess of $65 million. This relationship will cost HL&P consumers over $600 million over the life of the contract. To further illustrate the absurdity of this

relationship, if there were no transmission lines connecting the cogenerator to our system we would still be paying this cogenerator $65 million a year!

- **Reliability of service is also jeopardized. We have seen first hand how unregulated power suppliers, seeking to rely on force majeure provisions in contracts, cut and ran in the face of Hurricane Gilbert in August of 1988. While our employees were implementing emergency preparation efforts to insure that our statutory obligation to serve was met, the cogenerators were having their attorneys review their contracts to determine how they could avoid their contractual obligation to** serve. Proponents of PUHCA amendment suggest that contractual controls are a sufficient substitute for physical control over generating unit operations. Our actual operating experience clearly establishes such is not the case:

Actions speak louder than words!

Not surprisingly, cogenerators are using every available means to insure that these opportunities for abuse do not come to an end. The same groups that sold us the legislative package that gave rise to the abuses I have just outlined, now have a new scheme to sell: PUHCA amendment. PUHCA amendment, they say, is everything PURPA is and more. How much more of such a "good thing" can consumers stand? PUHCA amendment constitutes the gold rush of the 1990's and the gold deposits are found in the pockets of the American consumer. To illustrate just how strong the greed of these developers is, one cogenerator in our system has even claimed that we are required to continue a more expensive purchase power contract with them past the end of its contract term, at a cost to our consumers of more than $400 million. As bad as this seems, the economic cost of PURPA abuses will pale by comparison to the abuses which will occur under PUHCA amendments.

Make no mistake, to perpetuate the opportunity to profit at the utility customer's expense these groups will stop at nothing. Senators, the proponents of PUHCA amendment did not come to you first. They began at FERC, but the NOPRs failed for lack of public support. With no way to get what they wanted administratively, IPP proponents have now turned to Congress. Do not be deceived, their motive is the same as it has always been -- retail transmission access to end users, either through the courts or through Congress.

Non-regulated generators, are aggressively seeking access to the transmission system of the nation's electric utilities with the express purpose of expanding the markets for their own power, regardless of the hardships such expansion would impose on most electric consumers. If retail transmission access is obtained, IPPs will seek to increase their profits by "cherry picking" the utility's large industrial customers, leaving the remaining customers (primarily small commercial and residential) to shoulder the burden of the entire electric system. Not only would the remaining customers be left to pay the cost of the electric utility system to serve them, they would also be required to pay the cost of maintaining sufficient capacity to accommodate the needs of the large industrials should they decide to return to the utility system. The bottom line is that retail transmission access completely undermines the regulatory compact and would dramatically drive up costs for consumers.

When PURPA was passed, we lacked experience. We now have experience. Let's not make the same mistake twice. A century of accomplishment by the electric utility industry is being brushed aside in favor of industry restructuring.

For what reason?

- Are construction cost savings likely? Absolutely not. Construction costs savings -- to the extent there are any -- will only come through trade offs in design and reliability. The same contractors that build utility power plants will build IPP projects. But with no statutory obligation to serve, does anyone really believe that such developers will install the operating systems necessary to insure reliable operation when such systems erode project profitability? Certainly not.

- Will there be savings in financing costs? Absolutely not. Savings in financing depend on the IPP developer using highly leveraged debt financing backed by the credit of the utility and ultimately its consumers. Standard & Poor's and Moody's have already issued reports criticizing the impact of such transactions on the credit of utilities.

- Will there be savings in fuel and operating costs? Absolutely not. We are the second largest consumer of natural gas in the world. Our natural gas price is among the lowest in the country and few cogenerators can compete. IPP proponents also claim that PUHCA amendment will encourage gas consumption. Fuel choice does not depend on who builds the capacity, but on relative fuel price economics.

A number of consumer groups are similarly concerned about the dangers associated with continuing efforts to create a new class of unregulated power producers. You should not ignore the protests raised against the proposed amendments posed by the National Association of Regulatory Utility Commissioners or consumer groups like the Consumer Federation of America, the National Association of State Utility Consumer Advocates, Public

Citizen, the Environmental Action Foundation and Citizen Action, as well as, labor groups like the Texas AFL-CIO.

As the PURPA track record indicates, what looks good on paper often fails miserably in practice. Industry restructuring is not only dangerous, it is unnecessary. Utilities are already constantly exploring new opportunities for efficiently and reliably meeting the needs of consumers. For example, my company is presently pursuing the possibility of developing rate based, utility-owned cogeneration plants. Unlike a QF or an IPP project, however, our projects will flow the fuel efficiencies inherent in cogeneration to our consumers, not project developers. Rather than funnelling billions of dollars from residential and commercial consumers to a few large cogenerators -- as has been the case under PURPA -- these projects will save our consumers money.

The same groups that urged change in the form of PURPA, and have profited at the electric consumer's expense since its enactment, now seek the creation of a new class of unregulated power supplier to use as a new vehicle for profiting at the expense of our consumers. S. 341 endorses the creation of this new class of power producers reliant on the highly leveraged financing schemes and complex corporate structures that the 1935 Act prohibited. Senators, we must uphold the regulatory structure that guarantees the protection of the consumer -- one that, although adopted in 1935, is just as important today as it was when it was first written. One need only look to the

savings and loan industry to get an idea of the cost and harm to the consumers of ill conceived deregulation schemes.
Now that the S&L's have been plundered to the fullest, PUHCA amendment represents the "new frontier" for profiteers.

This is a consumer issue. While America has quelled aggression half way around the world, we are here talking about paving the way for an all-out assault on the American consumer! Hopefully, the consumers will be heard. Because if they are, there will be no more talk of PUHCA amendment.

Thank you.

The CHAIRMAN. Let me say, Mr. Jordan, to you and Mr. Smith, I take very seriously what you say. You are very respected in the industry. You run great utilities. You are long-time friends. You make a lot of sense. However, one thing that comes to mind right now when you are talking about PURPA, it seems to me there are some fundamental differences between your horror stories under PURPA and under this bill.

Number one, this is consensual. That was a required purchase. Secondly, those horror stories I am sure had to do with early purchases under PURPA when experiences of State commissions was not so much, when they were not done competitively, and when the cost of fuel in 1978 was at its top, as I recall. Section, what was it, 301, natural gas, where the deep gas was selling at about $9 an MCF at that time, so avoided costs as calculated would be very high. And therefore, it is easy to see when you make an avoided cost determination in 1978 or 1979, that would be a very high one.

But most important is the question of consensual nature. I mean, this was supposed to be consensual. Everybody has said it is. You do not have to purchase. And in previous years, Mr. Smith used to come in and say that, well, the PUC's will find ways to require you to do it, and therefore we will not be able to make our own planning. Well, that is why we put in the provision that allows those who object to file this irrevocable statement with FERC that would say we cannot be part of and we cannot purchase for 10 years.

But I see here in your statement, Mr. Smith, you say it would be unwise politically for a utility to take its commission to court to seek to enforce a Federal right of election in the face of a state commission preference for increased reliance on EWG power for some reason. Are you saying that in spite of the fact that our bill at present says it would be illegal for the PUC to communicate that to you and, secondly, that says it would be illegal for you either to purchase or be part of, that they would somehow require you to purchase from an EWG to do a double illegality, that is, to communicate something which is illegal to communicate and then require you to purchase when it would be illegal?

Mr. SMITH. Senator, I am not going to predict that any State commission in a particular jurisdiction would do that. But what I am saying is, in the real world of being pervasively regulated that justice has been testified to here before by some of the Government witnesses. The system of regulation is pervasive and it can be very difficult for a regulated entity to act in a way that its regulator disproves of, whether you are speaking of a Grand Gulf situation which Senator Bumpers asked about, whether you are speaking of the—if I could call it the opt-out provision which is in title XV.

I understand the reason for that being in, and I understand that to be your very sincere desire that this be a purely voluntary situation, and I appreciate that. But I do not believe that it is possible in this legislation to guarantee that it will work out to be purely voluntary. And secondly, there is another area which is not even covered, where the utilities have substantial jeopardy. And that is State commissions do not regulate sales at wholesale to municipal systems and REA's.

And filing a declaration with your commission if you were a utility serving an area that you did not intend or need to buy EWG power might certainly, if carried out, protect the utility at the State level. But the States have no authority over the sales to municipal systems and REA's, and an EWG could be built tomorrow. It could go to a municipality and say, we are financed entirely with debt. We can assure you of lower prices in the near-term perhaps, because of spot natural gas. We can undersell your existing electric utility that may have invested billions of dollars in plants to serve that load over the long time.

The municipality can then contract with EWG forced transmission wheeling, and there is nothing at all that is in this legislation that would protect it.

The CHAIRMAN. Well, now, that is an unrelated question. Let us get to that in a second. I want to get to this opt-out provision, because it is being criticized as going way to far. And you are saying it is no protection at all. It is inconceivable to me—I mean, this bill passes, let us say, January the 1st, 1991, and you file this declaration and you say, Carolina Power and Light cannot be a part of this for 10 years. Now, who is going to do what to you and how are they going to do it?

Mr. SMITH. Well, I have not said that this will not be protection. What I am saying is, it may or may not be protection, because you do not know what else will happen. None of this takes place in a vacuum, and that is a problem with the wheeling issue. When we leave this room and go out in the real world, producing and selling electricity——

The CHAIRMAN. We are not talking about wheeling. I am talking about the opt-out provision now.

Mr. SMITH. That is what I am talking about. When we leave this room and you go out into the real world there are many things that are going to influence the decision that the utility may make as to whether or not to utilize that opt-in-opt-out provision. And you cannot provide, in my opinion, through legislation, complete protection. You certainly can provide some protection, and in many cases it could turn out that that would provide the utility the protection that it needed at the State jurisdictional sales level. But there is no guarantee of that and there is no assurance of that.

The CHAIRMAN. Well, in 1989 we were talking about that utilities would lose the control over their decisions as to whether they could make power or not—I mean, to generate power, and that they would be forced by the PUC to buy power from their favorite kind of generator, and that might be unreliable and that might be financially risky, you might have imputed debts, you might have all of these things you have talked about. Surely, this opt-out provision would protect against that, would it not?

Mr. SMITH. It may provide protection in many situations, but in my opinion it will not assure the utilities of the type of protection that I believe you intend. There is another part of the opt-in-opt-out provision which is strange to me, and I would like to inquire, if I may respectfully, as to the reason for that. The opt-out provision says that if a utility let us say in the State of Texas does not need EWG generation and decides to opt out in Texas, then title XV let us assume has passed. That utility wants to invest in an EWG that is going to sell in North Carolina. The utility in Texas could not do that. I do not understand the logic of that.

The CHAIRMAN. Well, I mean, it is kind of equal justice. If EWG's are—it is sort of opt all the way in or opt all the way out. I mean, I think—that was the thinking behind it.

Mr. Jordan, tell us about what you think.

Mr. JORDAN. Mr. Chairman, I think the bill if it were to pass with the amendment, and I hope it does not, but if it does I think it is better with the opt-in/opt-out provision in it. The threat that I see in the whole thing—and I do not think that I am fencing with a ghost or shadows, because that has not been my history throughout the entire time I have been in this business. I think it is a very simple kind of formula. This is simply a very first step that IPP's want to take, and if they do that it makes it easier for them to get to where they ultimately want to go, and that is to get retail access into the transmission systems.

If this bill passes, it would make no difference, really, on that issue, whether or not somebody opted in or out anywhere around the country, because anywhere that a unit got built with excess capacity that the courts would allow them to move it through to pick up some other customer would affect all of us around the United States.

The CHAIRMAN. Let me zero in, if I may, on this opt-in/opt-out, because that is a very important issue, I think, and it was one that I personally designed to try to assuage your concern. And if it does not do it, well, I do not want to put up with all the opposition from the other side.

Mr. JORDAN. I understand that, and I think it is helpful to a lot of companies——

The CHAIRMAN. Is it really helpful or is it just nice to have?

Mr. JORDAN. No. I think it is helpful to a lot of companies, but I do not think it solves the problem that troubles me more than any other. And that is, I think there is no question but what this is the first step in a long-term plan to get into that transmission access.

The CHAIRMAN. I understand that. I do not want to get into that at this point.

Mr. JORDAN. The bill does that whether the opt-in/opt-out provision is in it or not. It is much better to have it in there than not to have it in there, but it does not protect against that ultimate, I think, threat.

The CHAIRMAN. Mr. Smith, do you really care whether it is in or out, opt-in or opt-out? I know you are against the bill, whether it is in or out, but do you really care, because everybody else strongly opposes it?

Mr. SMITH. Well, I think Mr. Jordan correctly summarizes it. The bill with the opt-in/opt-out provision in it is less offensive, we believe, than if it did not have that provision. And as he said, I think, in some places it may give utilities some protection, and to that extent I think it adds value to the bill.

The CHAIRMAN. Would it not also give you sort of bargaining power with your PUC to the extent that the PUC was a little but unreasonable with you—you have not opted out yet. If they were unreasonable with you, you would always have, in effect, the atom bomb in your pocket where you could go file that.

Mr. SMITH. It is hard to take away from the State PUC's the right to second-guess anything that the utility does. And suppose utility A does not need EWG power, opts out, and either builds its own plant or makes some other arrangements. The State utilities commission always jurisdiction over the rates. And to say utilities commission in theory could come along 5 years later and say, we are going to disallow from your cost of service on which your rates are based the alternate that you selected instead of EWG power because we had some preference for EWG power. Under the prudence——

The CHAIRMAN. They usually do that on prudence, but if the did it would it not be because EWG power proved to be more competitive, able to be generated at lower cost? Would that not be the measuring stick by which they——

Mr. SMITH. You would probably never know what the EWG power turned out to be. I might have been projected to be let us say 5 cents a kilowatt hour, but the plants never——

The CHAIRMAN. But in the rest of the country economies of scale, good management, all of those things that proponents of EWG's talk about, if they set a standard that was lower than others, that is how you would find out that it was a lower standard.

Mr. SMITH. Senator, the cost varies so much from site to site and from project to project. There could be no national standard that would have any meaning that could be used for that purpose.

The CHAIRMAN. Gentlemen, as far as I am concerned I have gotten caught by the clock. We have got a 2:00 hearing and I have got to go make a speech in the meantime, so Mr. Craig, let me let you—I think Senator Conrad was here first.

Senator CONRAD. I think Senator Craig was here first.

The CHAIRMAN. If you will question as long as you wish and then Senator Conrad as long as you wish, as long as it does not go past 2:00 it is okay with me.

My apologies to this panel. It is an excellent panel, and I wish I could probe a little further, Mr. Jordan.

Mr. JORDAN. The invitation is open to you, Senator.

The CHAIRMAN. We will do that in writing, because I think your points are serious and they get to very heart of this matter and I appreciate all of your testimony. We will ask more questions in writing. But for me, thank you very much, and please proceed.

Senator CRAIG. Mr. Chairman, before you depart let me state that earlier in the hearing this morning you mentioned the witnesses this afternoon will testify on, I believe you worded it, a proposed amendment to address the State public utility commission jurisdiction.

The CHAIRMAN. On this multistate holding company, Pike County provisions, along with some other things this afternoon.

Senator CRAIG. The reason I mentioned that, I think there is a concern that Members of the minority have not seen the proposal that you are talking about as it relates to specific amendment; is that correct?

The CHAIRMAN. I do not know. I thought you had seen it, but you will see it right now; here it is.

Senator CRAIG. Well, I say that, and let me say for the record that certainly on behalf of myself and members of the minority——

The CHAIRMAN. I understand that minority staff has been involved.

Senator **Craig**. The minority staff tells me that is not the case.

The **Chairman**. Well, if it was, we will try to correct that.

Senator **Craig**. Let us work that out so that we make sure that we can have opportunity to view that amendment. Mr. Chairman, thank you.

I have a couple of questions. First of all gentlemen, thank you very much for your testimony. Let me address this particular question, or two questions. First of all, to you, Mr. Berry or Mr. Elston, if either of the two of you could respond to it. Why could an independent power producer not—and I guess the term that I could effectively use would be "cherry-pick" a large industrial customer of an electric utility by getting a nearby municipality which is not subject to State public utility commission regulation to act as a reseller of IPP's power to an industrial firm? Do we have the risk of that in relation to this proposed legislation?

Mr. **Berry**. I think you have the risk of that under the current regime. And there are a number of instances where that particular gimmick is being tried. Just to try to understand how it might particularly relate to an independent power producer as opposed to a QF facility—and really, as far as that issue they are the same.

If you are talking about an existing municipal distribution system and a nonutility generator within that municipal distribution system, then there is nothing under present law that would prevent that municipality from saying, okay, you can serve my industrial customer. There is nothing that I know of that would prevent him from doing that today or under this bill. I would comment he would be presenting his electric operation with some pretty serious problems. I cannot figure for the life of me why he would want to do that, but he could do that to himself.

If you are talking about an industrial customer that is outside of the municipality, then you get into the transmission access issue. If you are talking about a generator that is outside the municipality, you raise the transmission access issue. But within the municipality he could shoot himself in the foot if desired to do so now, and under this law he could still shoot himself in the foot.

Senator **Craig**. Either way, you feel that possibility would exist or could exist?

Mr. **Berry**. Yes. I cannot figure out what his motive for exercising it would be, but it would exist.

Senator **Craig**. Mr. Elston.

Mr. **Elston**. I think Bill has answered the question fully. To me it is an example of an existing problem that either munis or other types of utilities have that they want to turn around and lay it on this particular amendment to the holding company act, when in fact it just does not exist. The relationships just do not exist. Almost all the objections that I hear have some validity in terms of the concerns of the utility executives, whether they be municipal or not.

But the question I think that you have got to sort through is whether those problems and those issues that are being raised are pertinent to this particular piece of legislation. And I have failed so far, after careful examination, to see these relationships. We talk about retail wheeling. I do not know how to deal with that. This legislation says nothing about retail wheeling. And it may be that sometime in the future the Congress will decide to deal with the issue of retail wheeling.

But certainly nobody that I have heard of has ever suggested that this bill or any version of it should include retail wheeling, should present the problems of stranded investment and bypass the utilities. These are legitimate problems but they certainly have nothing to do with this legislation that is before the Congress.

Senator **Craig**. Let me address one more question probably to you two gentlemen. Senator Wirth this morning in his comment spoke of this concern and I would like to get your response to it. Should the competitive advantage that IPP's enjoy as a result of high debt financing and deductibility of interest be addressed in this legislation?

Mr. **Berry**. Well, you start with the premise that there is a competitive advantage.

Senator **Craig**. Take that assumption.

Mr. **Berry**. Let me say first of all that I do not accept it as a premise. I do not believe they have a competitive advantage, and I would love to comment on that. But let us say—as you say, let us presume that there is a competitive advantage. It is the same advantage that the utility could achieve through a sale lease-back of its facilities, as a number of utilities have done.

It is the same advantage that a utility could achieve by creating a separate generating company that would have a separate debt structure and a different debt structure from its own. So it is possible for utilities to use financing mechanisms that would gain that same advantage for them.

And I think you also have to understand that if the State utility commission is concerned about this level playing field, as Senator Wirth brought, and they have created an unlevel field by arbitrarily setting some debt limit for the utility and therefore creating this perceived advantage, assumed advantage, then they can make it go away. I mean, they can change that. They have complete control over that.

They can control the utilities debt structure or they can by rule control the independents' debt structure. But ignoring all that and assuming, as you have required, that there is an advantage, and assume that the State has created this situation and refuses to do something about it even though it is an unlevel playing field, you have to come down to the fact that the beneficiary of that is the consumer, because the cost of power is then going to be cheaper than it would if it bought under a less optimum capital structure.

If the State commission decides that the consumer ought to be the beneficiary in spite of these perceived disadvantages, I think you would have to accept that judgment. I do not believe that advantages exist in the first place, but those are the thought processes that flow out of that first assumption that you made.

Mr. **Elston**. If I could just add a comment to that. I think that you have got to ask yourself, why do regulators put these requirements on utilities to, say, go with a 50/50 debt equity ratio? Because these are issues that come before my corporation as to how much debt and how much equity. And clearly, if I have less debt my equity is cheaper. Okay? And if I have more debt my equity is higher. Now, that is an economic relationship that the markets respond to.

So the regulators say, well, we want you to have lower debt ratios and you will have lower equity. Of course, people invest in utilities, expecting a fairly low rate of return, but a certain rate of return. So I think that the logic that really motivates the regulators in the first instance is then confirmed by the report that we heard from Senator Johnston which shows that in fact when you add it all up and look at the 30 years or 40 years of depreciation versus the 15 or 20 years that the independents have and other factors like that, that it evens out; that there is not a differential; that this is just a lot of hocus pocus.

The fact of the matter is that the cost of capital to independents is not cheaper than that of utilities. It will vary from project to project. And you have got to distinguish in your mind, it seems to me, the difference between corporate financing and project financing. Those are very different animals. And when you talk about the debt-equity ratio of the utilities, you are talking about their corporate debt-equity ratios.

When I talk about debt-equity ratio I am talking about a project. And I would argue with you that the markets are much more efficient at coming in and looking at the inherent risk in the projects that are there before you start talking debt-equity ratios, and sizing that up and then determining what the right leverage is on the project. And of course I am trying to optimize and reduce my cost so that I can bid a lower price and ultimately pass that across to the consumers.

But I would argue that the markets are better measures of that than are the regulators. And the markets get expressed through the bankers, in my case. When I go for project financing, these bankers come in and they turn me inside out and they turn the project inside out. They look at the engineering plans and the regulatory requirements and the projections. And they look at the equipment and the guarantees of the equipment supplies.

And they want to make sure that if they are going to give me debt and I am going to raise equity or put my own equity into this that they are sure that they are going to get paid back. And that is a real discipline. You know, they come in and kick the tires before they will put that money up. And it is just the opposite of corporate financing. Corporation financing you are looking at the corporation as a whole. You are not looking at a specific project.

So I would argue that the process of project financing associated with independent power producers and QF's is a very positive discipline that has been brought into this system, forcing us to define risk, allocate and price risk in a way that really does produce efficiencies.

Senator CRAIG. So you are suggesting in title XV no value in leveling the playing if in fact this creates an irregular field.

Mr. ELSTON. And I am saying that the irregular field is not there and we are better off having the market set these ratios than regulators.

Senator CRAIG. Mr. Smith, do you wish to respond to that?

Mr. SMITH. Yes. Thank you, Senator Craig.

I am sure that Mr. Elston would not wish this body to be either underinformed or misled. I understood his testimony to be that his cost of capital was about the same as utilities when you sort everything through. I would simply suggest that Mr. Elston file with this committee the cost of capital for his projects that he has just identified, Mr. Berry will file his company's cost of capital, Mr. Jordan will file his company's cost of capital, we will file ours, and we will look at the numbers.

The leading proponents of this legislation, the ones that are building the big projects, Ocean States in Rhode Island, another one in New York, have said they will be fully leveraged if they can, financed 100 percent by debt. And they have been able to obtain take-or-pay contracts under PURPA from the utilities that guarantee that the utility will have to pay that. And that is why they can finance those projects at 100 percent debt, and that is why they may be 10 to 20 percent cheaper. That is a pure matter of fact. That is not a matter of opinion.

Mr. ELSTON. If I could just correct the record. What I referred to was Senator Bennett Johnston's study of the debt cost, the equity cost. I was not referring to or asserting what my own was. I would not know that offhand. But I can tell you that I have no take-or-pay contracts, and my knowledge of Ocean States does not suggest that they have either. I really question that.

Thank you all. I will turn it over to you, Kent.

Senator CONRAD. Well, let me go back to this same issue, because as I review the questions that have been raised here this morning, the thing that continues to trouble me is the question of the debt to equity relationships, the riskiness of the structures that we would be creating and fostering through this legislation. And I would very much like to go back to this question.

We heard testimony from the SEC this morning that by regulation they require a debt to equity relationship of 65/35. That is, there has got to be at least 35 percent equity in a project for them to give their approval. Is there any reason why we should not require in this legislation that there be that same relationship with respect to these projects? And if there is a reason why we should not, what would it be?

Mr. Elston.

Mr. ELSTON. Well, I think that—at least the testimony that I thought I heard was—and I am not an expert on registered holding companies and the nature of the regulation, but I thought I heard him say that that ratio is applied on a corporate level as opposed to applied on a specific project level. And I think that that is night and day in terms of what issue we are looking at.

And again, I do not represent myself as an expert on the holding company, so I do not really want to talk to that. But if you were to lay an arbitrary debt-equity ratio on project financing where the banks are coming in, that does not hurt my business, because everyone presumably is subject to the same problems. But it certainly will cost the ratepayer something. That is what will happen. That is a cost that will get pushed right through to the ratepayers.

So the question is, what is the benefit from it and why lay that cost on the ratepayers? I could deal with it. My only problem is if you lay something difficult on me that my competitors do not have on them.

Senator CONRAD. Mr. Hempling.

Mr. HEMPLING. If I may, Senator, I would agree with Mr. Elston that a specific legislated ratio is not as important as a forum to go to in advance to create the monitoring procedures and the protections necessary to protect customers if the risks come home to roost. The issue is not so much that we are reducing risk or increasing risk with a leveraged capital structure or a less leveraged capital structure, but how do we handle it when things do go wrong.

And I must emphasize that the history in our industry is that we do not handle it very well. I will give you two brief examples. One is the bankruptcy of Public Service of New Hampshire where the result of bankruptcy was not to assign all costs to the stockholders and creditors, the people who ostensibly take the risk of loss. Only a portion of the loss went to them. A very large portion of the loss did go to the ratepayers of New Hampshire.

Similarly, Consumers Power in Michigan, one of the leading proponents of this particular legislation, had an unfortunate experience with a nuclear power plant in the mid-1980's that did not get NRC approval, and it went into deep financial difficulty. And its response was what are euphemistically called financial stabilization rights which, in effect, were above market rates charged to the captive customers.

Those two examples in my view represent a situation where our rhetoric about risk bearing is not necessarily the same with reality. Now, I am going to be the first person in this room to say we should new competitors into the industry. But the question remains, will we have a forum? Will we have minimum standards? Will be have backstops to ensure that when risks go wrong we have a place to go? I do not think the legislation as we have it today has adequately considered that question.

Senator CONRAD. Do you have specific recommendations with respect to the legislation that would correct those defects?

Mr. HEMPLING. On that specific point, Senator, my written testimony does have some specific recommendations. But I believe the dialogue on that issue of risk bearing is just beginning. I think we do have to be creative, and I am not sure the answer certainly exists yet.

Mr. ELSTON. Senator, could I just comment on that a second?

Senator CONRAD. Yes.

Mr. ELSTON. I think that it is, again, a mistake to try and legislate one solution across the board here. My contracts answer the question very definitively as to what happens if I go bankrupt. And this is typical, once again, of project financing contracts.

Assuming that that intensive scrutiny that I am subject to by the banks fails, that they make the misjudgment, and when it is all done they finance a project and I put equity into a project that goes bankrupt, that fails, my contract provides—the asset is sitting there, it has been built according to the specs in the contract which the utility has set, it provides for the utility to step in and run that asset.

So consumers are not hurt because I made a bad business judgment. I lose my equity in the project, and that is the way it ought to go. And the ratepayer ought not to be hurt, and that is what the contracts provide for.

Senator CONRAD. But if you have no equity in the project, what are you out?

Mr. ELSTON. I do have equity in the project.

Senator CONRAD. But I am asking the hypothetical. If we have situations in which there is 100 percent debt, and we are hearing testimony that there are projects in which those who are building the projects are attempting or seeking to have 100 percent debt or as close to is as they can, then what are you at risk?

Mr. BERRY. The only entity that I know that you can get 100 percent debt is the U.S. Government. No bank around is going to lend anybody 100 percent debt.

Senator CONRAD. Well, I tell you, I wish you would be here and go through the S&L catastrophe we have gone through. And I tell you we find loads, loads of examples of 100 percent debt. And you have financial structures in this country that went right along with it. In fact, I could show you dozens of examples that had 120 percent debt.

Mr. BERRY. And the only reason that happened is because the Federal Government backed up their loans from depositors. So again, I would say the only source of 100 percent debt financing is the U.S. Government.

Senator CONRAD. Let me ask each of you what you have heard the other side say today that you think requires a response. One of the things that happens in these hearings is everybody gives their testimony and answers the questions that we have. Often, you may hear something the other side has said that you think really requires a response for the record.

I would be very interested in giving each of you the opportunity. Is there something that you heard here this morning from the other side, another witness, or one of us that you think requires a response?

Mr. Berry.

Mr. BERRY. I would like to comment on one thing that Sherwood said. He pointed out that the recovery of capital costs in an independent project, a nonutility project, is different than it is in a utility project. The contract with independents sets a fixed price that you pay for the capacity charge. Generally, it is level or close to level over the life of the contract.

That means at the end of the—as compared to a utility project, it has very, very high first year costs, because you put the full plant in rate base and depreciate the whole thing. And then those costs come down, so that at the end of the life, the utility project is cheap. And he pointed that out, that at the end of life the utility financed project under rate base would be cheap compared to the independent.

What he failed to point out is, the reverse is true in the first year; that the utility project is much more expensive in the early life of the project than the independent. And I think you ought to have the balance of both of those views.

Senator CONRAD. Good point. Mr. Hempling.

Mr. **Hempling**. Yes, Senator. I have a response to something the chairman said, if that would be permitted.

Senator **Conrad**. No, that is not.

[Laughter.]

Senator **Conrad**. Go ahead.

Mr. **Hempling**. He made the statement that there were studies he would put in the record that indicated that competition was thriving without a regime where competitors had access to the transmission highways. I want to emphasize two points in response.

We can always find a region of this country where there are competitors and maybe even competition at this time. The question is whether there is going to be permanent competition in every region. That is response number one. Number two, Senator, I am a litigator. I am the one who sits in the hearing rooms at the Federal Energy Regulatory Commission. I cross-examine the witnesses.

I see utility companies who control transmission access, Pacificorp and Utah Power and Light, or Southern California Edison, or other utilities controlling transmission highways who do not negotiate fairly, who do not have interest in the consensual process, who do have interest in using transmission monopolies to create generation monopolies. That is what has been permanent in this industry.

We may have temporary places where there are competitors, but there is nothing in this bill that assures the permanence of competition, nothing in this bill that speaks to areas like the northwest, like the northeast where single companies have regional strangleholds over the transmission highways.

Senator **Conrad**. Mr. Jordan.

Mr. **Jordan**. Senator, you are exposed to a lot of hocus pocus and puff talk as somebody said down on the other end of the table. And the thing I guess that offends me and I think perhaps is confusing to maybe members of this committee is that you hear a lot of general talk about innovation, and imagination, and good management, and efficiency, and cost savings, and all those things that IPP supposedly do better than do utilities.

Nobody ever offers you any kind of justification or proof on those questions. They just say, we can do it better than they can, we can do it cheaper than they can. I do not think they have a patent on that, and I do not believe they can do it cheaper, better, more efficiently, and serve the customer in a better form. I think members of this committee and anybody who is going to vote on this issue ought to make them prove some of those points, and not just make general statements that appear to be true.

Senator **Conrad**. Mr. Smith.

Mr. **Smith**. Senator Conrad, there were several statements made by Government witnesses this morning with which I take issue. But I think the fundamental issue that I take with the thrust of the witness from the Department of Energy and from the FERC with regard to the effect of this bill is simply to interject more competitors, more competition into the industry.

And in response to that, rather than just use my own words I will refer to a talk that I believe Mr. Hempling referred to by Ronald E. Russell, Commissioner. He gave this on the 8th of this month before a group of the American Bar Association. And with respect to that, whether this simply lets in more competitors, and I will quote:

"If it is the will of Congress to remove the protections that the Holding Company Act provides, let them clearly understand that in so doing they are creating no only a new category of competitors, but also resurrecting and energizing a group of 'anti-competitors' who may seek to take unfair advantage of their monopoly power."

Senator CONRAD. Mr. Elston.

Mr. ELSTON. There are two things I would like to address, one by way of reemphasis. Don Jordan's analysis that I have heard before is basically a retrospective on what flowed from roughly 1980 to 1984 contracts when oil prices and gas prices were very high, and then looks back a decade later and says, well, if we had known that we could have done much better.

And I saw this kind of analysis in New York State when we were debating before the public service commission. And it was interesting that what the commission did in New York State was to apply that same standard of looking back and seeing whether the utility had made good decisions. And they did it, though, on their nuclear plants. And suffice it to say that the analysis of what QF's had cost the ratepayer were a rounding error in the analysis they did on the nuclear plants.

So I think it is a standard of analysis that Don Jordan would not apply to his own utility, and I do not think it serves this debate to apply it to this situation, particularly, and for the reason that Senator Johnston said, that what we are talking about there is PURPA. And mandatory acquisitions as opposed to this voluntary regime, hopefully here, of the utility executive only buying if in fact they want to buy and they can see it as a good deal for the ratepayer as well as the utility.

The second point, just to further add at least my own experience in trying to identify why it is that independent power, I think, does lead to efficiencies in the system, it is not because there are better people in independents or in utilities. But I think the fundamental structure is what we are talking about.

I have talked to equipment suppliers who supply equipment to me, and they do not particularly like this competition. They were much happier when there was a cost of service situation that they had to deal with, because we put them through hell when they are trying to bid for our stuff.

When a utility signs a contract with me, which Bill Berry has, and lays deadlines on me and me meeting that deadline is dependent upon whether or not that equipment supplier can deliver his equipment on time, you bet your life that I will write into that supplier's contract that they better deliver on time or they are going to pay the penalties because they are the ones that can control it.

And the principle here is a simple one and that is, if you are a business man accepting a risk in a business deal you will ask for a price for it, obviously. No one gives away anything for free. And it is much more efficient to have someone that can control a risk to take that risk and to charge a price for it than it is to have someone else take that risk.

And I think that there is plenty of evidence that the cost of service system which, in essence, passed most of the risk through to the ratepayers did not provide the discipline that the contract system that is part of competitive power I think forces on me, and then I force back on my suppliers who can really control that risk. So I think that that combined with the ability to replicate projects in different areas are two very specific things that I can point to that I think begin to account for the efficiency of competitive power as opposed to the cost of service power.

Senator **Conrad**. Mr. Jordan.

Mr. **Jordan**. If I could have an opportunity to respond to that. Let me say, I do not understand why Mr. Elston would think that we do not negotiate those contracts just as hard as does he, that we do not have dates that properties have to be delivered, and that we do not have penalties in our contracts just the same as he does. Our people work as diligently as any of his do in terms of negotiating that contract to get the prices at the very best rates.

But he is a little bit wrong in terms of how these mismatches occurred back in the early 1980's. It was a situation then when the public utility commissions took a look at the laws that were passed by Congress and had the Fuel Use Act in place where electric utilities in this country could not build gas-fired generation. We had to build coal-fired or lignite or nuclear. And as a matter of fact, that provision required that by 1989 we get totally off the use of natural gas.

During that period of time, independent producers could, in fact, build natural gas-fired power plants, but they measured that cost against what it would cost us to build a more expensive coal or lignite unit. That caused those huge differentials to take place. It happened under law, it happened under correct contracts under law, and they are still into effect and, in our case, will not expire until 1994.

The case that we are facing today is somewhat different than that because those big, huge rewards are not available to independent power producers who go out or cogenerators who go out today, because today we can build the same kind of plant they build, and our avoided costs can be calculated on that. That is why I think there is not as much activity in those areas and that is why you are seeing so much pressure being placed on this committee today to try to do something that eventually will lead to another kind of windfall.

It was passed unintentionally by Congress in 1978. You largely correct a part of it in 1988. I do not blame them for wanting to go back and get you to pass something else that is going to let them get those same kind of returns in the 1990's, but I do not think it is right.

Mr. **Elston**. But it seems to me that Mr. Jordan is pointing to the fact that, yes, there were problems in the beginning of putting in place PURPA. And he then points out the fact that things have tightened up, as they always do. And things are much more rigorous even in the area of mandatory purchases. But to argue, then, that a loophole that is going to open up profits is a voluntary purchase system is counterintuitive to me.

Senator **Conrad**. Any last comment from anyone?

Let me just say that I think both panels this morning were absolutely excellent. This is a difficult issue. I have spent and I know other members of the committee, certainly the chairman, have spent a significant amount of time trying to address this issue, and we are not done yet. But both these panels this morning I think have been of significant assistance to the committee in reaching a result, and we appreciate your time and your consideration.

[Whereupon, at 1:35 p.m., hearing was recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

The CHAIRMAN. The hearing will resume.

This afternoon's panel is an outstanding group composed of Thomas R. Kuhn, who is president of Edison Electric; the Honorable Joe Giarrusso from New Orleans, who is City Council president—a great friend of mine and a great public servant, I might add, accompanied by Clinton Vince, with Verner, Liipfert law firm, and Councilman Lambert Boissiere; the Honorable Patricia M. Eckert, who is president of California Public Utilities Commission; Charles A. Patrizia, with Paul, Hastings, Janofsky and Walker, representing registered utility holding companies; and Dr. Mark N. Cooper, Director of Research for the Consumer Federation of America, from Silver Spring, Maryland.

Our first witness will be Tom Kuhn, with Edison Electric.

And I understand, Mr. Kuhn, you have to leave to go attend to your corporate business this afternoon, and so you will be certainly excused when you need to leave.

STATEMENT OF THOMAS R. KUHN, PRESIDENT, EDISON ELECTRIC INSTITUTE

Mr. KUHN. I apologize, Senator. I do have to get back to a board meeting. It is always advisable not to miss your own board. They might do something that you might not like.

Good afternoon, Mr. Chairman. I am Tom Kuhn, president of the Edison Electric Institute, the association of the Nation's investor-owned electric utilities. Member companies of EEI generate approximately 78 percent of the power produced in this country and serve approximately 74 percent of all ultimate customers.

EEI congratulates the committee for undertaking the Herculean task of examining the many energy issues facing our Nation. We believe electricity must be considered an important part of solving our energy problems. Increased electrification of the economy can contribute to energy independence, efficiency, economic growth, and the environment.

One of the most compelling attributes of electric supply in the United States is its high degree of reliability. When someone turns on a light switch, utilities are able to provide the power needed instantaneously over 99.9 percent of the time. Providing reliability means having all segments of the power system, generation, transmission, and distribution working together to keep supply and demand in balance at all times. This requires careful monitoring, management, coordination, and control of the system.

EEI's member utilities are committed to meeting our customers' needs with highly reliable service at the lowest reasonable cost. The reliability and efficiency of our electric system remains the envy of the world, and we are committed to keeping it that way. The issues presented by proposed changes to the Public Utility Holding Company Act are complex, and it is no surprise to you that there are divergent viewpoints within the electric utility industry.

There are honest and strongly held differences of opinion over what changes would result from the proposed legislation and whether the potential benefits of increased competition outweigh the potential adverse consequences. Despite these differences, there are areas of strong agreement among EEI member companies relative to many of the issues which this debate raises.

First, electric utility affiliates must be able to participate in wholesale generation markets on an equal basis with all other entities. Second, electric utilities with an obligation to provide reliable service to customers must retain managerial discretion and flexibility to decide how their future power needs are to be met. Third, the provision of transmission services must remain voluntary. Utilities that currently have the responsibility of managing, planning, and operating the power supply system must maintain the ability to do so.

In addition, we believe that there must be grater clarity and certainty in the regulatory process so that utilities can have greater predictability in planning for their future customer needs. In this regard, proposals which would either change the current balance of Federal/State jurisdiction or add an additional layer of regulation at the regional level cause us great concern. The current Federal/State regulatory scheme is in large part based on the technical nature of the power supply system and should not be changed without very careful consideration as to the consequences.

On the subject of equal participation. Concerns have been raised by some that if PUHCA is amended, utility-owned entities should not be allowed to compete as electric wholesale generators for meeting their affiliated utilities' future needs. These concerns are based on the fear that first, utilities would engage in unfair self-dealing. Second, they would use their regulated business to subsidize competitive businesses, or third, they would use their ownership of transmission to gain undue advantage in a competitive market.

Not allowing utilities or their affiliates to compete with new entrants would be contrary to the consumers' best interest. It would result in the exclusion of some of the most experienced players. And if competition is the goal, exclusion of utility affiliates would result in less competition, not more. Under any future scenario, States will continue to regulate the retail sales of utilities.

The CHAIRMAN. Mr. Kuhn, if you will suspend, we are halfway through a roll-call vote, so I have got to go vote, and I will be right back.

Mr. KUHN. Absolutely, Mr. Chairman.

[Recess.]

The CHAIRMAN. We will pick up where we left off with Mr. Kuhn.

Mr. KUHN. Thank you, Mr. Chairman.

Continuing on the subject of equal participation. Under any future scenario, States will continue to regulate the retail sales of utilities and FERC to sales for resale or wholesale transactions. Both FERC and every State commission have the ability and authority to ensure that utilities, when purchasing from an affiliated entity, do not give undue preference or do not cross-subsidize.

Finally, in accepting filed rates for wholesale sales, the FERC has full authority to ensure that the utility does not use its ownership or transmission or generation in a way which gives them an unfair competitive advantage.

On the subject of management discretion, the decision to build under traditional regulation, to build as an EWG, or to buy from other utility or nonutility generators or some combination is a critical decision with respect to a utility's ability to satisfy its State-mandated service obligation. As long as utilities have the obligation, they must be given both the responsibility and the ability to make power supply decisions with appropriate regulatory oversight.

The decisions which must be made to ensure reliability and efficiency, including the appropriate utility fuel mix, preferred plant locations, schedules for maintenance, and the need for generating unit dispatchability must be made by the entity responsible to the customer and the regulators. This utility discretion is balanced by the equally broad discretion regulators have in setting rates and determining the prudence of managerial decisions.

Finally, on the subject of transmission access. Many proponents of mandatory transmission access are trying to use PUHCA reform as a vehicle to accomplish what they have been unable to accomplish since the very beginnings of the electric utility industry, customer-wheeling or bypass. Such bypass occurs when certain wholesale or large retail customers of utilities use their local utilities transmission lines to shop for power. Every time this issue of bypass via customer-wheeling has come before Congress, Congress has recognized that this is a destructive form of competition which has no efficiency benefits.

Mandating transmission services for large wholesale or retail customers would simply raise the cost of power for other smaller customers of the utility without the economic clout to shop for the power. Wheeling between utilities that are not directly connected with one another has increased dramatically over the last two decades, over a tenfold increase. The current voluntary framework within which this substantial transmission access has been provided will continue to serve to reduce the overall cost of power production while ensuring that reliability is maintained.

Where utilities can provide transmission services to utility or nonutility generators without harming their own native load customers or system reliability, they have and will continue to provide such services. And if the concern is that utilities will use their ownership of transmission to unfairly advantage their own affiliates, FERC already has all the tools it needs to prevent that. Mandatory transmission is neither necessary or desirable.

In conclusion, let me again stress that while there is a divergence of opinion within the industry on whether changes to

PUHCA are either necessary or desirable, there are areas of a strong agreement among EEI member companies relative to many of the issues which this debate raises. Specifically, there must be first, equal participation by utility affiliates, second, the management discretion for electric utilities which have an obligation to provide reliable service to customers, and third, voluntary transmission access which ensures reliability, efficiency, and equity.

We look forward to working with the committee as it considers all aspects of the comprehensive energy strategy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Kuhn follows:]

TESTIMONY OF
THOMAS R. KUHN

BEFORE THE UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
HEARING ON TITLE XV OF S. 341
THE NATIONAL ENERGY SECURITY ACT

MARCH 14, 1991

I. INTRODUCTION

Good afternoon Mr. Chairman and members of the Committee. I am Tom Kuhn, President of the Edison Electric Institute (EEI), the association of the nation's investor-owned electric utilities. Member companies of EEI generate approximately 78 percent of the power produced in this country and serve approximately 74 percent of all ultimate customers.

I very much appreciate the opportunity to appear before you today. EEI congratulates the Committee for undertaking the herculean task of examining the myriad of energy issues facing our nation. We believe electricity is a critical component of our Nation's economy and should be considered as an important part of solving our energy problems. Increased electrification of the economy can contribute to energy independence, efficiency, economic growth, and the environment.

The member companies of EEI are strongly committed to maintaining a reliable and efficient electric power supply system. In fact, one of the most compelling attributes of electric supply in the United States is its high degree of reliability. When someone turns on a light switch, utilities are able to instantaneously provide the power needed over 99.9 percent of the time. Providing reliability means having all segments of the power system -- generation, transmission, and distribution -- working together to keep supply and demand in balance at all times. It also requires careful monitoring, management, coordination, and control of the system.

I can say unequivocally that EEI's member utilities will continue to meet our customers' needs with highly reliable service at the lowest reasonable cost. The reliability and efficiency of our electric system remains the envy of the world, and we are committed to keeping it that way.

The issues presented by proposed changes to the Public Utility Holding Company Act of 1935 (PUHCA) are complex and it is no surprise to you that there are divergent viewpoints within the electric utility industry itself. There are honest and strongly held differences of opinion over what changes would result from the proposed legislation and whether the potential benefits of increased competition outweigh the potential adverse consequences. Earlier today you heard from several EEI member companies who expressed at least some of the range of views within the industry.

II. INDUSTRY VIEWS ON PROPOSALS FOR PUHCA REFORM

Despite these differences, there are areas of strong agreement among EEI member companies relative to many of the issues which this debate raises. I want to stress these areas of consensus, which we believe are critical to assuring that electric consumers are provided with adequate, reliable and environmentally acceptable service at the lowest reasonable cost.

First, electric utility affiliates -- whether affiliates of a registered holding company, an exempt holding company, or of a utility which is not a holding company at all -- must be allowed to participate in wholesale generation markets on an equal basis with all other entities.

Second, state regulated utilities, with their statutory obligation to serve their customers, must retain full management discretion to decide how that service will be provided.

Third, the provision of transmission services must remain voluntary. Utilities that currently have the responsibility of managing, planning, and operating the power supply system must maintain the ability to do so.

In addition, whatever scenario one assumes for the future, we believe that there must be greater clarity and certainty in the regulatory process to give utilities greater predictability in planning for their customers' future needs. In this regard, proposals made by some in the context of PUHCA reform which would either change the current balance of federal/state jurisdiction or add an additional layer of regulation at the regional level cause us great concern. The current federal/state regulatory scheme is in large part based on the technical nature of the power supply system, and should not be changed without very careful consideration as to the consequences.

Finally, given the current environment of the electric utility industry and all of the regulatory changes being proposed, we believe policy makers need to recognize the importance and need for balancing utilities' risks and rewards. Maintaining this risk/reward balance is critical to ensuring the continued efficiency of our nation's electric power system.

III. BACKGROUND – THE ELECTRIC POWER SYSTEM TODAY

In considering any changes to the regulatory framework within which the industry operates, we believe care must be taken not to jeopardize the many benefits which customers receive from the nation's existing electric power supply system. The U.S. electric power supply system is second to none.

The electric power industry differs substantially from the gas industry or just about any other industry, because of electricity's unique physical properties. First, unlike gas, electricity cannot be practicably stored. Electricity must be generated at the instant it is required -- when a customer flips a switch. Second, electricity physically cannot be directed from a particular generating source to a particular end-use customer. Power simply flows within the system according to the laws of physics.

Operating within the constraints created by the physical properties of electricity , it is the regulated utility's job to ensure that generation is always sufficient to meet demand -- on a moment to moment basis, and that transmission lines and distribution systems are not overloaded. The assurance of continued reliability is the regulated utility's number one priority. All other considerations must take a back seat to that priority. The costs to consumers of not doing so are just too great.

Adding to the system's complexity, but also to the consumer benefits it produces, is the fact that every electric utility in the U.S. is interconnected in one of three transmission grids. There are also interconnections with Canada and Mexico. Within each of the interconnected grids, power flows freely, governed only by the laws of physics. The nation is further divided up into utility control areas. A control area is a geographic boundary within which there is one utility (or grouping of utilities in the case of power pools) that has responsibility for ensuring that generation, when added to net power flows coming into the control area, always matches demand. If supply and demand ever get out of balance, the system becomes unstable and serious disruptions of service or equipment damage could result. In fact, this was the cause of the major New York City blackout of 1967, when a sudden loss of generation in Canada could not be replaced fast enough to meet demand.

The extensive transmission interconnections between utilities provide significant benefits for utilities and their customers. They allow utilities to rely on each other in times of emergencies, thus reducing the level of reserve generating capacity any individual utility needs to maintain. They allow utilities to take advantage of economic opportunities by reducing their own generation and buying from other utilities whenever they can do it cheaper. And where economics dictate, interconnections allow utilities to formally combine their resources into a power pool with centralized dispatch of generating units within an entire region. Altogether, it is estimated that interconnections allow savings to customers in excess of 15 billion dollars every year.[1]

However, to gain the benefits of inter-utility power sales and purchases, utilities must also live with responsibilities which interconnection entails. Most important, an interconnected transmission network requires that there be careful coordination among all of the interconnected utilities. This coordination is done through utility control centers. Every trade between control areas must be analyzed to ensure that transmission capacity exists to conduct the transaction, and every trade must be scheduled by the affected control areas to maintain system stability. And because electricity does not follow predetermined "contract" transmission paths, but rather flows within the interconnected network along the paths of least resistance, each utility control area within an interconnected grid must be willing to immediately withdraw from its own economic transactions if they are jeopardizing the reliability of other utilities. Operating procedures to ensure continued reliability are governed by voluntary industry guidelines and criteria which have been developed by the North American Electric Reliability Council (NERC) and its regional reliability councils.

The system sounds fairly difficult to manage, and it is. But the benefits of interconnected operation far outweigh the costs. However, without coordination and cooperation to manage this complex system, reliability might be jeopardized. Moreover the substantial savings from inter-utility trade might be lost. In its 1989 report to Congress, the Office of Technology Assessment (OTA) pointed out the importance of considering the potential impacts of increased competition on coordination in the electric utility industry:

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[1] Cassaza, John A., "Free Market Electricity: Potential Impacts on Utility Pooling and Coordination". Public Utilities Fortnightly, February 18, 1988, Arlington, VA, p. 17.

> Maintaining reliability under competition also poses uncertainty. Most of us take the reliability of electric power for granted, but it doesn't happen by accident. It has required investments in equipment and manpower and emergency assistance to other utilities that at times have gone beyond legal requirements. Utilities have a deeply engrained ethos that interruption of service should be minimized....[However,] system reliability is as yet untested for a situation where a large proportion of components are operated under contract rather than under the direct ownership of a utility committed to meeting demand under all conditions.[2]
>
> If coordination is not addressed with appropriate care, the system may experience increasing costs and decreasing reliability.[3]

The number and type of wholesale sales for resale among interconnected utilities, and wheeling services for transactions between utilities that are not directly connected with one another, have increased dramatically over the past two decades. For example, the level of transmission services (wheeling) provided by investor-owned utilities has shown greater than a ten-fold increase in this period. And this increase has occurred without eroding service reliability precisely because it has been left to regulated utilities to determine how best to use their transmission systems. It is critical that utilities continue to maintain the management discretion and flexibility, with appropriate regulatory oversight, to respond to the changing needs of their own service area customers. Any proposals for regulatory change in this industry must ensure that this discretion and flexibility is maintained, and must not lose sight of the substantial benefits provided by the existing system.

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[2] Office of Technology Assessment. Electric Power Wheeling and Dealing: Technological Considerations for Increasing Competition. May 1989, Washington, D.C., p. 8.

[3] Ibid., p. 15.

IV. EQUAL PARTICIPATION BY UTILITIES

Concerns have been raised by some participants in the PUHCA debate that if PUHCA is amended, utility-owned entities should not be allowed to compete as "Electric Wholesale Generators" (EWGs) for meeting their affiliated utility's own future needs. These concerns are based on the fear that (1) utilities would engage in unfair self-dealing, (2) they would use their regulated business to subsidize competitive businesses, or (3) they would use their ownership of transmission (or generation) to gain undue advantage if there is a competitive bulk power market. I will address each of these concerns in turn.

Not allowing utility affiliated generators to compete with new entrants would not be in the consumer's best interest. It would result in the exclusion of some of the most experienced players. And if competition is the goal, exclusion of utility affiliates would result in less competition, not more.

It is important to recognize that under any future scenario, states will continue to regulate the retail sales of utilities, and FERC the sales-for-resale or wholesale transactions. Both FERC and every state commission have the ability and authority to ensure that utilities, when purchasing from an affiliated entity, do not give undue preference, or do not cross-subsidize. In fact, the issue of affiliate transactions is an issue which regulatory commissions have always had to deal with, in the context, for example, of utility fuel supply subsidiaries.

As to cross-subsidization, state commissions and FERC have full access to the books and records of regulated utilities within their jurisdictions. Such access allows regulators the opportunity and ability to detect any cross-subsidy abuses. Again, they have substantial experience in the context of other types of utility affiliates. We believe cross-subsidization issues are handled quite well by the existing regulatory system.

Finally, in accepting filed rates for wholesale sales, the FERC has full authority to ensure that a utility does not use its ownership of transmission or generation in a way which gives them an unfair competitive advantage. We believe that FERC currently has the authority it needs to ensure that non-cost based rates proposed by generation subsidiaries for sales to affiliated utilities are just and reasonable.

V. UTILITIES MUST MAINTAIN MANAGEMENT DISCRETION IN MEETING THEIR FUTURE NEEDS

Under any scenario of the future, I can say unequivocally that EEI's member utilities will continue to meet their customers' needs using all options available. Utilities **can** and **will** build new capacity when needed and when it is in the best interest of their customers. We have an obligation to serve existing and future customers -- an obligation we take very seriously. The reliability of our electric system remains the envy of the world, and we are committed to keeping it that way.

Control over the integration of the generation function into the entire power supply system is critical to maintaining a reliable electric system. In order to achieve integration, a single entity must control the system. The decisions which must be made to ensure reliability and efficiency - including the utility's desired fuel mix, preferred generating plant locations, schedules for maintenance, and need for dispatchability of the generating unit - must be made by the entity responsible to the consumer. Certainly it would be inequitable to impose an obligation to serve on the utility and take from the utility the discretion it needs to meet that obligation. The utility, therefore, needs the discretion to decide how it will provide the service for which it is answerable to state regulators.

In this context, EEI has long expressed concerns regarding the requirement to purchase from qualifying facilities under the Public Utility Regulatory Policies Act of 1978 (PURPA). In many cases, this has resulted in utilities being required to purchase capacity which is not needed or in a purchase price that is higher than the utility's true avoided cost. In either case, this has in turn resulted in electric customers paying higher rates than necessary.

Utility discretion is balanced by the equally broad discretion state regulators have in setting retail rates and determining the prudence of managerial decisions. This arrangement has worked well for customers. To continue to meet our customers' needs effectively and efficiently in the future, it is also important to have clarity and consistency in the regulatory process.

Whether a utility builds or buys, or some combination of both, a utility faces some of the same risks. For example, the risk involved in procuring power well in advance of when it is needed, with the uncertainty of whether demand will materialize as forecast exists whether a utility builds or buys. Utilities have faced an increasing number of after-the-fact prudence reviews with respect to their own construction programs, a development we believe has unbalanced the risk/reward relationship. And purchasing power does not necessarily reduce a utility's exposure to prudence reviews. It may simply shift the focus of prudence reviews from utility projects to utility purchased power contracts.

Thus, regardless of any changes to PUHCA, there is a need to focus on improving existing regulatory processes. Some members of EEI and the National Association of Regulatory Utility Commissioners (NARUC) have participated in a joint dialogue over the past year. Participants in this dialogue are currently discussing alternative regulatory options, such as the institution of up-front reviews of the prudence of constructing facilities, with periodic reviews during the construction process to ensure continued prudence. Whatever the result of this dialogue, we hope that it will focus attention on the need for improvements in the regulatory process.

Proposals have been made to shift the balance of federal/state jurisdiction or to add a layer of "regional regulation" to the existing regulatory framework. As we stated at the outset, we believe that there is a need for increased certainty and clarity in the regulatory process. Such proposals cause us great concern because, to the extent they reduce such certainty and clarity, they would increase risk and costs to utilities.

Defining the proper boundaries of state and federal jurisdiction is not a cut and dry issue. The current jurisdictional boundaries are the result of many years of Congressional mandates, state and federal regulatory decisions, and court decisions.[4] The impacts of changing this delicate balance need to be carefully studied before any changes are made.

With respect to regional regulation, most proposals would not give up state authority, but would rather add a layer of regional regulation above state authority. We believe that these proposals would unduly complicate and lengthen the regulatory process, reducing certainty and predictability.

We do, however, support informal, collaborative processes which allow state regulators to work together, with federal regulators and regulated utilities where appropriate, on issues of regional concern. Such informal processes might be particularly useful with respect to the siting and certification of multi-state transmission lines. Specifically, we believe that individual states should allow transmission line applicants the option to coordinate timetables with other states involved, and possibly provide for joint hearings on issues which are similar in multiple states. However, all of this can be done within our current regulatory framework.

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[4] Of particular note is the Colton decision of 1964 [FPC vs. Southern California Edison Company and City of Colton, CA vs. Southern California Edison Company. 376 U.S. 205, 84 S.Ct. 644, 11 L.Ed.2d. 638, reh. denied, 377 U.S. 913 (1964)]. There, the Supreme Court stated that under Part II of the Federal Power Act, "[f]ederal jurisdiction was to follow the flow of electric energy, [using] an engineering and scientific, rather than a legalistic or governmental test." (Emphasis in original.) Id at Note 5.

The decision to build under traditional regulation, to build as an "EWG", or to buy from other utility or non-utility generators (or some combination) is a critical decision with respect to a utility's ability to satisfy its customers' needs at the lowest reasonable cost. As long as utilities have a service obligation, they must be given both the **responsibility** and the **ability** to make power supply decisions, with appropriate regulatory oversight. And the regulatory process must provide certainty, clarity, and a proper balancing of risks and rewards.

VI. TRANSMISSION MUST REMAIN VOLUNTARY

Advocates of mandatory transmission access claim that such access would be a necessary component of PUHCA reform. We strongly disagree. As stated earlier, FERC (as well as state commissions) have all the tools they need to ensure that a utility or its affiliated independent producer (EWG) could not use its ownership of transmission to unfairly advantage itself.

Many of the proponents of mandatory access are trying to use PUHCA reform as a vehicle to accomplish what they have been unable to accomplish essentially since the very beginnings of the electric utility industry -- customer wheeling or bypass. Bypass occurs when wholesale requirements customers[5] or large retail customers of utilities use their local host utility's transmission lines to shop for power, whenever the "market" has prices which are lower than their local utility's regulated rates. (These same advocates believe that when a customer shops for power, a utility should not be relieved of its obligation to stand ready to provide service to that customer when needed.)

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[5] Wholesale requirements customers are utilities who are located within the control area of another utility and do not own generation sufficient to meet their own needs. Such utilities are thus reliant on their local host control area utility for all or part of their power supply needs in the same manner as a retail customer would be. Full requirements customers are dependent on their local utility for all of their needs, while partial requirements customers are dependent on that utility only for part of their needs. These customers are most typically medium-sized or small municipal or cooperative power distribution systems.

Every time this issue of customer bypass, be it for retail or wholesale requirements customers, has come before Congress, most recently with the passage of the Public Utility Regulatory Policies Act (PURPA) in 1978, Congress has recognized that this is a destructive form of competition which has **no** efficiency benefits. Mandating transmission services for wholesale requirements or retail customers would simply raise the cost of power for other, smaller customers of the utility without the economic clout to shop for power. This occurs because utilities would be left with stranded capital investments -- costs which it would have to recover from its remaining customers. In addition, because utilities are obligated to meet all existing and future customer needs within their franchised service areas, and because of the long lead times typically needed to build new generation, allowing customer bypass would make resource planning increasingly difficult, if not impossible. In any case, costs to remaining customers would increase.

We believe that the current voluntary framework within which transmission access has been provided will continue to serve to reduce the overall costs of power production while ensuring that reliability is maintained. Where utilities can provide transmission services to utility or non-utility generators without harming their own native load customers or system reliability, they have and will continue to provide such services. Mandatory transmission is neither necessary or desirable.

Many proposals for mandatory access would give priority use of the transmission system to third party wholesale transactions over use for a utility's own customers. This would limit the ability of utilities to conduct economic (and perhaps even reliability) transactions on behalf of their own customers, and thus severely limit the flexibility of utility management in power supply decisions. Again, mandatory access would impede the ability of utilities to fully meet their customers' needs at the lowest reasonable cost.

Perhaps most importantly, mandated access would take decisions on the control and use of the transmission system out of the hands of those responsible for maintaining a reliable power supply system. While imposing a few "mandated" transactions on the system may not be a problem, if the number of non-utility generators and accompanying transmission service requests grows substantially, it would become more and more difficult to maintain reliability if the utility can not plan, manage, and control the use of its transmission system. The importance of maintaining a reliable system far outweigh any of the alleged benefits of an open access transmission system.

If reliability can be maintained, a utility has every incentive to provide transmission service to third party generating suppliers, provided that its own customers are not required to subsidize such service.

VII. CONCLUSIONS

Again, let me stress that there is a divergence of opinion within the industry on whether changes to PUHCA are either necessary or desirable. But despite these differences, there are areas of strong agreement among EEI member companies relative to many of the issues which this debate raises. Specifically:

(1) **All electric utility affiliates must have the ability to participate in wholesale bulk power markets on an equal basis with any other participant;**

Those who argue for prohibitions against self-dealing argue that an electric utility-owned entity not be able to build as an EWG to serve its own needs. We believe such a prohibition would not be in the consumers' best interest. It would result in the exclusion of some of the most experienced players. And if competition is the goal, exclusion of utility affiliates would result in less competition, not more.

There are adequate and substantial customer protections built into existing regulation. FERC and the state commissions currently have all the tools they need to prevent utilities gaining unfair competitive advantage if there is a competitive procurement in which the utility or its affiliate is involved.

(2) Electric utilities, with an obligation to serve customers reliably, must retain full management discretion and flexibility in meeting future power supply needs;

Regardless of whether or not changes are made to PUHCA, there is a need to focus on improving existing regulatory processes. We support informal, collaborative processes which allow state regulators to work together, with federal regulators and regulated utilities where appropriate. We oppose any changes which would add an additional layer of regulation onto an already difficult process. And great care must be taken when considering changes to the current balance of state and federal regulatory jurisdiction.

(3) Finally, the current voluntary framework for transmission access, which ensures efficiency, equity, and reliability, must be maintained;

Under any future scenario, the current voluntary framework for transmission access must be maintained. The voluntary framework ensures that needed transmission is provided without jeopardizing reliability, and without harming a utility's own customers. Mandatory transmission is neither necessary or desirable, and would make the maintenance of the most reliable electric power system in the world difficult. And there would not be any gains to efficiency which would outweigh the potential costs.

We look forward to working with the Committee as it considers all aspects of a comprehensive energy strategy.

The CHAIRMAN. Mr. Kuhn, thank you very much for an excellent statement on behalf of EEI. We will continue to work with you as this bill develops. I know you have to get to your meeting, so if you need to be excused.

Mr. KUHN. Thank you again, Mr. Chairman. I appreciate your indulgence. We would be glad to answer any questions that might be submitted in writing.

The CHAIRMAN. We will have written questions.

Mr. KUHN. Thank you, sir.

The CHAIRMAN. Next, we are very pleased to hear from the president of the New Orleans City Council, Joe Giarrusso.

STATEMENT OF HON. JOSEPH I. GIARRUSSO, PRESIDENT, CITY COUNCIL OF NEW ORLEANS

Mr. GIARRUSSO. Good afternoon, Senator. My name is Joseph Giarrusso, and I am President of the City Council of New Orleans, Louisiana, and chairman of the council's utility committee. The council regulates New Orleans Public Service, Inc. and Louisiana Power and Light, two utility subsidiaries of the Entergy Holding Company System.

With me today, to answer any questions of a technical nature, is my fellow councilman, Lambert Boissiere, who will be back very shortly; Clinton Vince; Ken Carter, and Mike Tiff, our legal advisers on energy matters to the City Council.

Thank you for giving us the opportunity to testify today on the provision of the National Energy Security Act which proposes to amend PUHCA.

The council wishes to express its concerns to ensure that any changes that are made to the Act to not harm consumers in New Orleans and throughout the country. In 1985, the voters of New Orleans returned regulatory authority over NOPSI and LP&L to the council as a result of the threat the Grand Gulf plant presented to ratepayers in New Orleans.

When the plant was originally constructed, we were promised that nuclear power would result in cheaper electric bills for our consumers. Instead, Grand Gulf has been an economic disaster for our community and the entire region. We have taken an active role in utility regulation to try to protect consumers in New Orleans as much as possible. In fact, we are still involved in litigation over Grand Gulf. However, because of Federal preemption, FERC has forced New Orleans to pay for a large share of a plant which is not even located in Louisiana and which we do not need.

The council understands that the electric utility industry is on the verge of change, and we support any modifications that will benefit consumers. However, we are deeply concerned about the impact an amendment to PUHCA could have on ratepayers in New Orleans and throughout the country. It is our understanding that an amendment to the Act could give Entergy and other holding companies even more power to make generation decisions, authority which is rightly ours as a State-level commission.

Secondly, permit Entergy and other holding companies to spin off valuable generating plants off system to the detriment of consumers in New Orleans without effective regulatory review. New

Orleans' position is laid out in greater detail in our written testimony which we have submitted to the committee. Suffice it to say that we believe that Congress, in amending PUHCA, should make sure that ratepayers throughout the country are adequately protected to prevent the occurrence of future mini Grand Gulfs.

We note that our sister utility commission from Arkansas has submitted written testimony today highlighting similar concerns, and we have received expressions of support from State regulators across the country.

Mr. Chairman, we appreciate the opportunity which you have given us to express our views to you over the past year and a half. Both you and committee staff have been extremely cordial throughout. We hope to continue to work closely with you in addressing the problems that we feel are facing out consumers. I wish to thank you, and we would be happy to answer any questions that you have for us later on.

[The prepared statement of Mr. Giarrusso follows:]

STATEMENT OF
THE HONORABLE JOSEPH I. GIARRUSSO
PRESIDENT
CITY COUNCIL OF NEW ORLEANS, LOUISIANA

before the

COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
Room SH-216

March 14, 1991

Mr. Chairman and Members of the Committee:

My name is Joseph Giarrusso, and I am President of the City Council of New Orleans, Louisiana and Chairman of the Council's Utilities Committee. The Council regulates NOPSI and LP&L, two utility subsidiaries of the Entergy holding company system. With me today is Clinton Vince, a legal advisor on energy matters to the Council. Mr. Vince is available to answer any technical questions you may have.

Mr. Chairman, thank you for giving us the opportunity to testify today on the provision in the "National Energy Security Act" which proposes to amend PUHCA. The Council wishes to express its concerns to ensure that any changes that are made to the Act do not harm consumers in New Orleans.

In 1985, the Council regained regulatory authority over NOPSI and LP&L as a result of a public referendum, because of the threat the Grand Gulf plant presented to ratepayers in New Orleans. When the plant was originally constructed, we were promised that nuclear power would result in cheaper electric bills for our consumers. Instead, Grand Gulf has been a disaster for our community and the entire region.

We have taken an active role in utility regulation to try to protect consumers in New Orleans as much as possible. In fact, we are still involved in litigation over Grand Gulf. However, because of federal preemption, FERC has forced New Orleans to pay for a large share of a plant which is not even located in Louisiana, and which we do not need.

Mr. Chairman, the Council understands that the electric utility industry is on the verge of change and we support any modifications that will benefit consumers. However, we are deeply concerned about the impact an amendment to PUHCA could have on ratepayers in New Orleans. It is our understanding that an amendment to the Act could:

- give Entergy even more power to make generation decisions; authority which is rightly ours as a state level commission; and
- permit Entergy to spin-off valuable generating plants off-system to the detriment of consumers in New Orleans without effective regulatory review.

New Orleans' position is laid out in greater detail in our written testimony which we have submitted to the Committee. Suffice it to say, we believe that Congress, in amending PUHCA, should make sure that ratepayers in New Orleans and throughout the country are adequately protected to prevent the occurrence of future "mini Grand Gulfs." We note that our sister utility commission from Arkansas has submitted written testimony today highlighting similar concerns and we have received expressions of support from state regulators across the country.

Mr. Chairman, we appreciate the opportunity which you have given us to express our views to you over the past year-and-a-half. Both you and Committee staff have been extremely cordial throughout. We hope to continue to work closely with you in addressing the problems that we feel are facing our consumers.

Thank you, and we will be happy to answer any questions you may have.

TESTIMONY OF THE CITY OF
NEW ORLEANS, LOUISIANA
ON TITLE XV OF
THE NATIONAL ENERGY SECURITY ACT
S. 341

before the

COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
Room SH-216

I. INTRODUCTION

The City of New Orleans, Louisiana ("New Orleans")[1] respectfully submits its testimony concerning Title XV of S.341, "The National Energy Security Act," which proposes to amend the Public Utility Holding Company Act of 1935 ("PUHCA").[2] New Orleans supports a narrow amendment to PUHCA to promote competition in wholesale generation and thus provide benefits to consumers. However, we are concerned that in the rush to amend PUHCA, the opportunities for utilities to take advantage of a modification of this consumer protection statute may be overlooked, leading to a situation that in the long-run will harm consumers.

New Orleans opposes amending PUHCA to exempt utility affiliated independent power producers ("IPPs").[3] We urge Congress, if it determines to permit utility affiliates, to provide for sufficient consumer protections. In addition, to an examination of the potential for abuse with respect to interaffiliate transactions, transmission access and cross-subsidization, the most important element necessary to ensure that an amendment to PUHCA works to the benefit of consumers is effective state regulation of utilities. New Orleans has drafted a proposal for inclusion in S.341, which is designed to provide state level regulators with sufficient authority to protect consumers (See Appendix A) by (1) codifying the Pike County doctrine and (2) authorizing regional regulation of multistate holding companies.

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[1] New Orleans has the duty to regulate electric utilities in the City of New Orleans pursuant to Article IV, Section 21 of the Louisiana Constitution of 1974 and the City Charter of the City of New Orleans, Louisiana. As such, the New Orleans City Council is a state level utility regulator. The City Council regulates the service, rates and charges of the two electric utilities serving the City -- New Orleans Public Service Inc. ("NOPSI") and Louisiana Power & Light Company ("LP&L"). Both of these companies are subsidiaries of the Entergy Corporation ("Entergy"), a public utility holding company registered under PUHCA. Entergy serves New Orleans, other parts of Louisiana, Arkansas and Mississippi.

[2] 15 U.S.C. § 79 et seq. (1988).

[3] For the purposes of this testimony, New Orleans defines an IPP as a company that does not serve retail ratepayers which owns or operates generating facilities used for wholesale sales of electricity. S. 341 makes no distinction between those IPPs which are affiliated with utilities and those which are not, using the term exempt wholesale generator ("EWG") instead.

II. SUMMARY OF TESTIMONY

IPP development could increase competition in wholesale generation and thus provide benefits to consumers across the country. While New Orleans fully supports furthering competition and believes that a narrow amendment to PUHCA may be necessary to promote this goal, sufficient regulatory protections are needed.

Utilities with affiliated IPPs could be tempted to make power purchase decisions favoring these entities at the expense of non-affiliates in their drive to gain greater profits in a less regulated sector of the industry. Utility monopoly access to transmission facilities may further prevent competitors from being able to reach the markets needed to successfully compete. In addition, consumers may be additionally threatened through subsidization of IPP development by charges made to retail ratepayers.[4] New Orleans believes that this Committee should exhaustively consider such issues and ensure that consumers are protected before permitting utility affiliates to be exempt from PUHCA. Clearly, further protections are essential to protect consumers against this type of potential abuse.

In New Orleans' view, the most important element necessary to ensure that PUHCA amendment benefits consumers, is effective state level regulation of utilities. Nevertheless, amending the Act to encourage the proliferation of generation companies will increase wholesale electric sales regulated by the Federal Energy Regulatory Commission ("FERC") and, correspondingly, reduce rate base construction of generation capacity subject to the jurisdiction of state commissions. It is critical that state regulatory authority over utility generation planning decisions be preserved in order to protect consumers.

Traditionally, state public service commissions have regulated utility generation matters, ensuring reliable and economical service for consumers. Such regulation has included oversight of utility wholesale purchase decisions to determine whether the utility chose the least-cost option in adding

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4/ For instance, a utility might shift lower cost fuel to affiliated IPPs and retain more expensive fuel for rate-base generating facilities where recovery is guaranteed. See Hempling, Corporate Restructuring and Consumer Risk: Is the SEC Enforcing the Public Utility Holding Company Act, Elec. J. at 40 (July, 1988).

capacity pursuant to what is known as the Pike County doctrine.[5] However, this judicial doctrine has come under attack from utilities seeking to avoid state review of their activities, arguing that FERC approval of a wholesale rate automatically requires state level regulators to pass through such costs in retail rates. New Orleans believes codification of Pike County is essential if PUHCA is to be amended. If this action is not taken, utilities may be able to avoid state regulation through wholesale activities.

With regard to integrated, centrally planned multistate utility holding companies, the Supreme Court's decision in Mississippi Power & Light Company v. State of Mississippi ex rel. Moore[6] has severely restricted the ability of states to review wholesale transactions between holding company affiliates which have been approved by the Federal Energy Regulatory Commission ("FERC"). As we have already experienced on the Entergy system, as a result of the Grand Gulf nuclear plant, such preemption can produce horrific results for consumers.

The decision to construct Grand Gulf resulted in one of the most expensive utility generation ventures in the history of the industry.[7] However, the Court's decision in Mississippi Power & Light prevented the state regulators on the Entergy system from reviewing the prudence of their jurisdictional utilities' participation in the project. Since Grand Gulf was owned and operated by a wholesale subsidiary, System Energy Resources, Inc. ("SERI"), and FERC allocated wholesale cost responsibility among the operating utilities, the Court reasoned that the state level regulator was preempted.

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[5] This doctrine received its name from a Pennsylvania case Pike County Light & Power Co. v. Pennsylvania Public Utilities Commission, 465 A.2d 735 (1983). In that case, the court held that the Pennsylvania Utilities Commission was not preempted from reviewing the prudence of a utility's wholesale purchase decision even though the rate set for the wholesale sale was approved by FERC.

[6] 487 U.S. 354 (1988).

If PUHCA is amended to permit multistate holding companies to create wholesale subsidiaries free from PUHCA review, holding companies may be tempted to add capacity through SERI-type facilities to avoid state level review of generation planning. Without sufficient regulatory protections, a PUHCA amendment could lead to the proliferation of numerous "mini-Grand Gulfs" among multistate holding company systems.

New Orleans has developed a proposed solution to this regulatory dilemma intended to protect the authority of state level regulators to oversee holding company generation decisions, while at the same time addressing the concern of multistate holding companies that one state's actions may affect the well-being of the entire holding company system. This proposal calls on Congress to authorize the state regulators in a multistate holding company system to form a regional compact to:

7/ When Grand Gulf was originally planned, it was projected to cost $800 million. However, it was completed at a cost in excess of $3.6 billion.

- regulate holding company generation and transmission planning;
- approve cost allocations among holding company affiliates; and
- review the prudence of holding company wholesale generation and purchases.

We believe that regional regulation has the potential to enable state regulators to protect consumers. In addition, by providing for regional oversight of generation planning, the potential for contentious after-the-fact litigation between the holding companies and the affected states should be reduced.

New Orleans is also quite concerned about another provision in S.341 which causes particular apprehension for consumers in multistate company systems. Section 1501(a)(3) of the bill would permit utilities to spin-off generation plants to affiliated IPPs with the approval of only the state commission which has rate-base authority over the plant. However, this restriction is not adequate for multistate systems.

Such a spin-off would likely have a significant effect on consumers of each system utility company while only one state commission would have authority to review the transaction. If Securities and Exchange Commission ("SEC") review of such a spin-off pursuant to PUHCA were removed, it is possible that no regulatory jurisdiction would have authority to protect the interests of such consumers. New Orleans urges that holding company spin-offs be explicitly excluded from the bill.

III. DISCUSSION

PUHCA was enacted in 1935 as a mechanism to protect against the use of the utility holding company corporate form to the detriment of both consumers and investors. The Act was and remains an important facet of utility regulation for the protection of consumers. By limiting the extent and scope of utility holding company operations, PUHCA attempts to ensure that utilities are focused on providing reliable and economic electric service to their traditional (retail) customers.

While in recent years some holding companies have undertaken activities which have arguably worked to the detriment of consumers, this has not been a failure of the Act. Rather, the SEC has unilaterally limited its role, declining to review holding company activities with regard to the protection of consumers.[8] This is a problem with SEC enforcement rather than the Act itself and should be dealt with as such.[9]

A. Consumers Must be Adequately Protected from the Effects of Amending PUHCA.

Title XV of S.341 is intended to spur the development of IPP growth in the industry, presumably to increase competition in the wholesale generation market. Currently, PUHCA imposes utility holding company status on all companies which own IPPs.[10] As such, since the Act limits holding company utility operations to that of a single integrated system,[11] severe restrictions are placed on the ability of all companies, including non-utilities, to own more than one IPP project and limits the potential for growth in the industry.

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[8] See, e.g., Entergy Corp., et al., Rel. No. 35-25136 (1990).

[9] Congress may want to explore the transfer of the SEC's responsibility under PUHCA to FERC, a commission which is more accustomed to the regulation of utilities.

Title XV of S.341 proposes to amend PUHCA to reduce the Act's restrictions on independent power development. Specifically, Title XV would exempt companies owning IPPs (referred to as exempt wholesale generators ("EWGs")) from PUHCA regulation as a result of that ownership. This provision makes no distinction between utility and non-utility ownership of IPPs and, in fact, specifically ensures that registered holding companies are included in the category of entities which could own EWGs.[12]

New Orleans opposes the amendment of PUHCA to exempt utility affiliated IPPs. We urge Congress, if it determines to permit utility affiliates, to examine the potential for abuse with respect to interaffiliate transactions, the means to assure access to transmission, and possible cross-subsidization. This

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[10] The Act defines a utility holding company to include a company owning ten percent or more of a company which owns or operates a generating plant. 15 U.S.C. §79b.

[11] See 15 U.S.C. § 79k. In order to have an integrated system, the holding company's facilities must be interconnected and operated as a single system. As such, a holding company may not own one plant in New York and another in California.

[12] S. 341, 102nd Cong. 1st Sess., § 15001(d).

Committee should provide for sufficient consumer protections before permitting affiliated IPPs to become exempt from PUHCA.

B. Adequate State Regulatory Authority is Essential for the Protection of Consumers.

If we are to ensure that IPP development works in the best interest of consumers, state and local regulators are going to have to play an important role. Traditionally, it has been the state commissions that have provided direct oversight of utilities as they planned and added capacity to provide economic and reliable service to their customers. State regulators have substantial experience in such a role and are well positioned to determine what is in the best interest of retail ratepayers. On the other hand, FERC primarily regulates wholesale sales and it is questionable whether that Commission has the expertise or even the authority to examine utility generation decisions.[13/]

1. Pike County Must be Codified

Any amendment to PUHCA that would promote IPP development would probably result in an increase in utility wholesale purchases subject to FERC jurisdiction and cause a corresponding

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[13/] It seems inconsistent that Title XV, which is intended to promote competition in wholesale generation, would contain a provision prohibiting state level regulators from requiring utilities which opt not to own EWGs from purchasing power from such entities. State regulators are best-positioned to determine what is in the best interest of retail consumers and surely, if purchasing power from an EWG is a more beneficial alternative than utility-constructed generation, these commissions must be entitled to require that this alternative be chosen (or at least that consumers do not suffer from an erroneous choice).

reduction in generation construction as part of a utility's rate base, subject to regulation at the state level. As a result, state regulators will be forced to increasingly resort to Pike County review,[14] to determine whether a utility generation decision was made in the best interest of consumers.

While Pike County authority protects the traditional oversight role of state commissions, there is some concern that this judicial doctrine could be subject to further preemptive challenges by the utilities and FERC.[15] While the legitimacy of the Pike County doctrine (in the non-multistate holding company situation) has yet to be successfully challenged,[16] utilities, faced with the opportunity to evade state review of wholesale purchases, no doubt will continue their opposition. The debate over Pike County should be ended once and for all with codification of the doctrine. If this occurs, consumers of non-multistate holding company utilities could reap the benefits of a more competitive wholesale generation market.

14/ See discussion supra note 5 and accompanying text.

15/ See, e.g., Testimony of the National Association of Regulatory Utility Commissioners on S.406 the Competitive Wholesale Generation Act of 1989, 101st Cong. 2d Sess. (Nov. 16, 1989).

16/ See, e.g., Kentucky West Virginia Gas Company v. Pennsylvania Public Utilities Commission, 837 F.2d 600 (3d Cir. 1988), cert. denied, 109 S.Ct. 365 (1988) (applying Pike County).

2. Regulation of Multistate Holding Companies Through Regional Compacts Will Protect Consumers.

Providing consumers of multistate holding companies with proper regulatory protection is a more difficult task. As a result of the Supreme Court's decision in Mississippi Power & Light,[17] the ability of state commissions to regulate generation decisions of multistate holding companies has been severely restricted. The Grand Gulf example is illustrative of this problem.

In the 1970's Entergy formed SERI to construct and own the Grand Gulf nuclear generating plant, one of the most costly plants in the history of the United States electric utility industry,[18] for sales to the system's retail utilities free from state review. Power from Grand Gulf was the highest priced in the region and resulted in economic hardship for, what was already, one of the poorest areas of the country.

In 1985, FERC allocated the costs of Grand Gulf among the four Entergy operating companies.[19] Thereafter, the Mississippi Public Service Commission approved Mississippi Power

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[17] 17/ See supra note 6 and accompanying text.

[18] 18/ See supra note 7 and accompanying text.

[19] 19/ Middle South Energy, Inc., Opinion No. 234, 31 FERC ¶ 61,305 (1985), reh'g denied, Opinion No. 234-A, 32 FERC ¶ 61,425, aff'd, Mississippi Industries v. FERC, 808 F.2d 1525 (D.C. Cir. 1987), rev'd and remanded, 822 F.2d 1104. On remand, System Energy Resources Inc., Opinion No. 292, 41 FERC ¶ 61,238 (1987), reh'g denied, 42 FERC ¶ 61,091 (1988), aff'd City of New Orleans v. FERC, 875 F.2d 903 (D.C. Cir. 1989), cert. denied sub nom., Mississippi v. FERC, 110 S.Ct. 1805 (1990).

& Light's ("MP&L") request to include its 33% share of the costs of the plant in its rates. The Mississippi Supreme Court remanded this decision to the Commission on the grounds that it had not considered whether MP&L had been prudent in agreeing to participate in the project. The U.S. Supreme Court reversed, holding that because FERC had allocated a certain percentage of responsibility for Grand Gulf to MP&L, the MPSC was preempted from reviewing the prudence of MP&L's acceptance of this percentage.[20]

This decision significantly constrained the ability of state commissions regulating multistate holding company utilities to protect consumers from generation activities undertaken at the wholesale level. Holding companies found themselves with the opportunity to avoid state review by creating subsidiaries to make wholesale sales to operating utilities subject only to FERC regulation.[21] If PUHCA is amended to permit holding companies to form subsidiary IPPs, free from the Act's constraints,[22] holding companies will find it much easier to avoid state level review[23], creating the potential for the proliferation of "mini Grand Gulfs" wreaking havoc for millions of consumers.

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[20] 487 U.S. at 369.

[21] For example, the American Electric Power ("AEP") System's formation of a wholesale subsidiary (AEP Generating Co.) worked to prevent state review of an affiliate purchase. Appalachian Power Co. v. Public Service Commission, 812 F.2d 898 (4th Cir. 1987).

[22] Currently, a registered holding company would not be permitted to add an IPP subsidiary without a prior showing that such subsidiary would produce savings for holding company consumers. *See* 15 U.S.C. § 79j(c)(2).

While a legislative provision overruling the Mississippi Power & Light case would remove the barriers existing for state regulation of holding company interaffiliate transactions, New Orleans recognizes that multistate holding company operations present special difficulties for state regulation. For instance, most multistate systems plan, construct and operate generation and transmission facilities for the benefit of the system as a whole. In addition, the effect of many transactions cross state lines.[24]

With this in mind, New Orleans has developed a comprehensive proposal designed to ensure that holding company activities can be effectively regulated at the state level. This proposal calls for Congress to authorize the state commissions in a multistate system to form regional compacts to regulate: (1) power supply planning (including conservation measures) by the holding company or any of its affiliates or subsidiaries; (2) the allocation of power and the accompanying costs from a wholesale subsidiary to two or more operating companies; and (3) the prudence of costs

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23/ Indeed, utility executives have come to view FERC as a "safe harbor" against state regulation. The Grand Gulf Mess-State Prudence Reviews Thwart FERC Rate Settlements, Pub. Utils. Fort., May 28, 1987, at 4.

24/ For example, the Entergy system makes capacity addition decisions through a central committee, with the goal of meeting the needs of all system operating companies. Mississippi Industries, 808 F.2d at 1529.

incurred by a wholesale affiliate in either constructing a generating facility or making a wholesale purchase.

New Orleans believes that all three authorities are necessary for the development of a regulatory approach that will ensure that holding company consumers are adequately protected. Not only can regional regulation serve as a means for state commissions to regain their traditional role in determining which costs may be properly charged to ratepayers, but also, the concept can work to ensure that proper capacity decisions are made early-on to avoid costly and contentious after-the-fact disputes in which state commissions attempt to protect consumers from suffering as a result of holding company mistakes. In addition, regional regulation would resolve concerns that state-by-state review of decisions makes it difficult for the holding company system to function as a whole.

While the New Orleans proposal would authorize regional regulation, it would not mandate state regulatory commissions to do anything. Formation of a regional board would be purely voluntary, requiring approval of all affected state commissions prior to the creation of the compact. In addition, a board could choose which authorities it would have within the boundaries of the three enumerated areas of regulation. If state commissions are satisfied with the current state/federal regulatory dichotomy they could maintain the status quo.

Further, if the regional board were unable to agree on a cost allocation or prudence review within a six-month period, the case would be referred to FERC to ensure a timely decision. Regional board decisions would only become effective upon either a majority vote of the members with a vote in favor from at least one representative of each state level regulator (the board would be comprised of two representatives of each state commission) or a vote in favor from both representatives of each state level regulator but one. In this way, holding companies would be prevented from structuring their activities in a manner to gain a single state veto of regional decisions.[25/]

The regional regulatory concept does not "add another layer of regulation" as some may charge. Instead, it fills a regulatory gap that has been created as a result of multistate holding company corporate manipulation. Congress should not amend PUHCA to permit these holding companies to have a greater ability to shift activities to wholesale subsidiaries to avoid effective regulation. Instead, Congress should enact strong protective measures, including the authorization for state commissions to form regional boards to ensure adequate regulation.

We note that New Orleans is not alone in calling for regional regulation of multistate holding companies. The Arkansas Public Service Commission, which regulates utility subsidiaries of two such systems (Entergy and Central and South

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[25/] For a more comprehensive discussion of the New Orleans model, see Vince, Quirk, and Glick, Regional Regulation of Multistate Holding Companies: A Model for Readjusting the Federal-State Boundary, Elec. J. 56 (Dec. 1990).

West) supports such a concept. In addition, the National Association of Regulatory Utility Commissioners ("NARUC"), the association representing state level utility regulators, recently reaffirmed its support for regional regulation in a resolution at its Winter Meetings.[26]

3. Staff's Proposal for State Regulatory Involvement at FERC, While Well Intentioned, is Inadequate to Protect Consumers.

The concerns expressed by a variety of groups that PUHCA amendment could exacerbate the difficulties facing state and local regulators in their protection of consumers did not fall on deaf ears. In fact, the Chairman of the Energy and Natural Resources Committee, Senator J. Bennett Johnston, in a speech presented to the 1990 IPP/PUHCA Symposium recognized the legitimacy of the state regulators' concerns and suggested the need for exploring several options, including the regional regulatory concept.[27]

Since that time, staff for the Committee has been meeting with a variety of interests including registered holding companies, NARUC and New Orleans, in an attempt to explore these options. New Orleans has been received very cordially in these meetings and believes they have been very productive.

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[26] See NARUC Bulletin No. 9-1991, p. 22-23. The resolution called for congressional authorization for the formation of regional boards to regulate multistate holding company cost allocations, interaffiliate power sales, emissions allowances related to the Clean Air Act Amendments and use of the system's transmission facilities. In addition, the resolution requests authority for such review for multistate transactions in non-holding company scenarios.

[27] Address by Senator J. Bennett Johnston, 1990 IPP/PUHCA Symposium (Mar. 8, 1990). See also K. Maize, "Johnston Offers PUHCA Concessions to States," The Energy Daily, Mar. 9, 1990.

Recently, Committee staff drafted a proposal which would:

- codify the Pike County doctrine;
- create a rebuttable presumption in favor of a wholesale rate for an interaffiliate transaction jointly proposed by the state regulators of a multistate holding company system;
- preempt state level review of the prudence of a wholesale purchase by two or more holding company subsidiaries from a non-affiliate and one subsidiary from an affiliate and FERC approved cost allocations[28]; and
- create a mechanism for up-front FERC review of a wholesale rate or charge prior to the construction of a generating facility if each affected state level regulator endorses the rate.

Committee staff should be commended for taking the time to develop a proposal intended to resolve what may be the most important threat to consumers of investor owned utilities. However, New Orleans believes that the proposal would not provide sufficient protection.

First, with regard to the rebuttable presumption in favor of a state developed rate, there does not appear to be a legitimate reason to provide holding companies with an opportunity to use FERC as a means to overturn a regionally approved rate. These are decisions which state regulators have traditionally made in

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28/ This provision attempts to do more than codify the Mississippi Power & Light decision by preempting state review of a wholesale purchase made by more than two holding company subsidiaries.

the absence of a multistate holding company preemption problem and as such, should remain with the state regulators. Surely, holding companies would use the opportunity to go to FERC to continue to evade state regulation.

While FERC has dealt with rebuttable presumptions under several different scenarios,[29] the Commission has not defined the term. Thus, there is no clear indication as to how the presumption would be overcome. In addition, the states would be given only 90 days following the issuance of an initial decision to develop a regional proposal. It would be inefficient to have an initial decision which may have little weight if a rebuttable presumption is given to a different result. Such a presumption would probably be more successful if given equal weight at the initial decision level as well.

As for the provision related to planning, there appears to be little potential for the state level regulators to be involved at the decisionmaking stage, where the holding company chooses to construct a certain facility or make a particular purchase. Instead, the provision unintentionally provides a means for

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29/ For instance, the Commission has created a rebuttable presumption in favor of the prudence of a gas utility's recoupment of costs in reducing take or pay or exposure, Order No. 500, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, FERC Statutes and Regulations ¶ 30,761 (1987); a finding that price discrimination is anticompetitive, Connecticut Light and Power Company, 8 FERC ¶ 61,187 (1979); and a finding that the issuance of a certificate under the Natural Gas Act is necessary in the public interest if certificate procedures and environmental statutes have been complied with, Kern River Gas Transmission Company, 51 FERC ¶ 61,195 (1990).

holding companies to avoid after-the fact review. Again FERC would be the focus of what has traditionally been a purely state function -- planning, an area which FERC is not accustomed to. If a holding company does not agree with the affected state commissions, it can wait to receive FERC approval, again avoiding state regulation.

New Orleans remains supportive of the regional regulatory concept. We believe that decisionmaking through a regional board would retain for the states their traditional role of regulating utility generation decisionmaking, while at the same time addressing the concerns of multistate holding companies. We hope to continue discussions with staff on the subject.

C. Holding Company Spin-offs Must Remain Subject to SEC Review.

New Orleans also wishes to express its concern about another provision in Title XV which poses special problems for consumers in multistate holding company jurisdictions. Section 15001(a)(3) would permit utilities to spin-off existing generating facilities to IPP subsidiaries free from PUHCA review if the state (or states) with rate-base jurisdiction over the facility approves. While the spin-off of an asset already paid for by a utility's traditional customers to a subsidiary for off-system sales and greater profits raises significant consumer interest concerns, the requirement of prior state commission approval may normally provide sufficient protection.

However, this protection is not available for consumers of multistate holding companies. While typically a utility plant is part of one operating company's rate base, that facility has been planned, paid by and operated for the entire system. Thus, while a spin-off will have an effect on the entire system, S.341 would require only that a single state, acting solely in the interest of its particular ratepayers, approve the transaction. By removing PUHCA as the mechanism which ensures that holding company activities with multistate impacts are effectively regulated,[30] the provision could leave consumers in all but one holding company jurisdiction entirely unprotected.

We have already seen an example of such a spin-off recently, when Entergy transferred two plants located in Arkansas to a newly-formed IPP subsidiary. While the Arkansas Public Service Commission found that consumers in Arkansas would benefit, regulators in Louisiana, Mississippi and New Orleans, which had no direct jurisdiction over the plants, had serious concerns that the spin-off could cause consumers substantial harm in their respective jurisdictions. These regulators challenged the transaction before both the SEC, under PUHCA and FERC, pursuant to the Federal Power Act.[31] FERC acted first stating it had no jurisdiction over the spin-off, deferring instead to the SEC.[32] The SEC approved the spin-off, refusing to hold a hearing and never examining how the transaction would impact consumers in New Orleans, Mississippi and Louisiana.[33]

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[30] One of the key purposes behind the enactment of PUHCA was to ensure that holding company activities occurring in more than one state would be effectively regulated. 15 U.S.C. § 79a(b)(3).

[31] 16 U.S.C. § 824 et seq. (1988).

Both the SEC and FERC decisions are currently on appeal to the United States Court of Appeals for the District of Columbia Circuit.[34] We believe that there is a strong likelihood that the court will overturn the approvals on the grounds that there was no examination of the effect of the spin-off on consumers systemwide. However, if S.341 were enacted, the opportunity for federal review of such a transaction would be greatly endangered and while not agreeing with FERC's jurisdictional interpretation, if it is upheld, there would be absolutely no protection. S. 341 should be amended to prevent registered holding companies from making such spin-offs free from PUHCA review.[35]

32/ Entergy Services, Inc., 51 FERC ¶ 61,376 (1990), reh'g denied, 52 FERC ¶ 61,317.

33/ Entergy Corp., et al., Rel. No. 35-25136 (1990). In fact, the Commission suggested that FERC was the proper agency to deal with such issues. New Orleans has already written Congressman Synar, Chairman of the Environment, Energy and Natural Resources Subcommittee of the Government Operations Committee, expressing its concerns about this "bureaucratic shell game." (See Appendix B).

34/ City of New Orleans v. SEC, No. 90-1493; Louisiana Public Service Commission v. SEC, No. 90-1501; Mississippi v. SEC, No. 90-1506; City of New Orleans v. FERC, No. 90-1494.

35/ At the very least, approval of all state utility commissions on the holding company system should be required.

IV. CONCLUSION

New Orleans hopes that the Senate Energy and Natural Resources Committee takes these and other concerns expressed by those representing consumers into account in acting on Title XV of S.341. Such a change to the industry could have a significant impact and should not be undertaken without sufficient protections. Most importantly, state regulators should not have their hands tied by utilities which can choose the forum in which they would prefer their transactions reviewed. With sufficient consumer protections such as Pike County codification and the authorization of regional regulation of multistate holding companies, we can proceed with the creation of a more competitive electric utility industry.[36]

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[36] New Orleans notes that the Administration's National Energy Strategy bill includes a PUHCA amendment provision similar to S.341. S. 570. While the bill would codify Pike County and provide other important protections, New Orleans' concerns about the regulation of holding company generation decisions, are not addressed.

APPENDIX A

PROPOSED AMENDMENT

Strike all after Sec. 15005 and insert the following:

"Sec. 15005. **PRESERVATION OF STATE AUTHORITY**

"Nothing in this Act, or any other Act, shall preempt or otherwise prohibit a retail regulator of a utility company from judging the prudence of a purchase of electric energy at wholesale, and deny the inclusion of the cost of such purchase in rates subject to the regulator's jurisdiction, or otherwise exercise its functions. Provided that, no retail regulator of an operating subsidiary may make such a finding, where a Joint Board, as hereafter provided, or the Federal Energy Regulatory Commission, has allocated the costs of a purchase from an affiliate, among two or more operating subsidiaries.

"Sec. 15006. **AUTHORIZATION OF JOINT BOARDS**

"(a) The consent of Congress is given for an agreement, by unanimous consent, among the retail regulators of operating subsidiaries of a registered holding company, pursuant to which there shall be established a Joint Board which shall

"(1) carry out its functions and responsibilities in accordance with the provisions of this section,

"(2) continue in force and effect in accordance with the provisions of this section for a term of five years, for which such term is renewable upon its termination, and

"(3) shall not be considered an agency or instrumentality of the United States for the purpose of any federal law.

"(b) Upon the establishment of the Joint Board, two persons shall be appointed by each retail regulator, subject to the applicable laws of each regulatory jurisdiction, to undertake the functions and duties of members of the Joint Board. The retail regulator may fill any vacancies occurring prior to the expiration of the Board's term.

"(c) The members of the Joint Board shall select from among themselves a Chairman. The Joint Board shall appoint, fix compensation, and assign and delegate duties to such executive and additional personnel as the Joint Board deems necessary to fulfill its functions under this Act. The compensation of the members shall be fixed by the laws of the regulatory jurisdictions.

"(d) All expenses, save the salary of the members of the Joint Board, incurred as part of the Joint Board's operations, shall be funded pursuant to fees collected from the registered holding company.

"(e) No decision of the Joint Board shall be final unless such decision receives the votes of

> "(1) a majority of the members, including the vote of at least one member representing each regulatory jurisdiction; or
>
> "(2) all members of the Joint Board, except those representing one jurisdiction.

"(f) The Joint Board shall determine its organization and prescribe its practices and procedures for carrying out its functions and responsibilities under this Act. The Joint Board shall make available to the public a statement of its organization, practices and procedures.

"(g) The Joint Board shall be empowered, pursuant to its rules of practice and procedure and the requirements of this Act, to, at its discretion

> "(1) review the registered holding company's plans to build generation or transmission capacity and/or purchase capacity to meet the energy needs of the operating subsidiaries, and require Joint Board approval of such construction or purchases;
>
> "(2) allocate the costs of and entitlement to electricity generated or purchased by any affiliated wholesale subsidiary from which two or more operating subsidiaries will be served; and
>
> "(3) review the prudence of the decision to construct, and the costs incurred in the construction of wholesale generation and transmission facilities and to disallow those costs imprudently incurred from being included in charges to the operating subsidiaries.

"(h) All Joint Board decisions requiring a finding on a material issue of fact, shall first be referred to an Administrative Law Judge employed by the Federal Entergy Regulatory Commission for an initial decision. The initial decision shall be made pursuant to the "just and reasonable" standards of section 824d(a) of title 16, United States Code.

"(i) Upon issuance, the Administrative Law Judge shall refer the Initial Decision to the Joint Board. The Joint Board shall

> "(1) have six months from the date of referral of the Initial Decision, or if there is no issue of material fact, from the date of the initiation of the proceeding, to issue a final decision in the proceeding, or
>
> "(2) upon expiration of the six months, refer the proceeding to the Federal Energy Regulatory Commission for that Commission's decision pursuant to the Federal Power Act and Commission rules of practice and procedure.

"Provided that, if the Joint Board fails to issue a final decision within six months upon its review of holding company planning, the proceeding shall remain with the Joint Board until a final decision is reached.

"(j) All final decisions of a Joint Board shall be given full force and effect by each retail regulator. No retail regulator shall act in a manner inconsistent with any final decision of a Joint Board. Provided that, neither this Act nor any other Act shall preempt a retail regulator from examining the prudence of a utility's actions with respect to allocated capacity.

"(k) The Joint Board shall at all times have access to and the right to inspect and examine all accounts, records, and memoranda of a holding company subject to regulation, and it shall be the duty of such holding company to furnish to the Joint Board, within such reasonable time as the Board may order, any information with respect thereto which the Board may by order require, and to grant all agents of the Joint Board free access to its property and its accounts, records, and memoranda when requested so to do. No member, officer, or employee of the Board shall divulge any fact or examination which may come to his knowledge during the course of examination of books or other accounts, as hereinbefore provided, except insofar as he may be directed by the Board or by a court.

"(l) In any proceeding before it or an Administrative Law Judge, the Joint Board, in accordance with such rules and regulations as it may prescribe, may admit as a party any interested person whose participation in the proceeding may be in the public interest.

"(m) Any party to a proceeding before the Joint Board under this Act aggrieved by a final decision issued in such proceeding may obtain review of such decision in the United States Court of Appeals for any circuit wherein an affected operating subsidiary is doing business, by filing in such court, within sixty days after the issuance of the final decision of the Joint Board, a written petition praying that the decision be modified or set aside in whole or in part.

A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Board and thereupon the Board shall file with the court the record upon which the decision complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. The finding of the Joint Board as to the facts, if supported by substantial evidence, shall be conclusive. The judgement and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended.

"(n) Nothing in this Act shall be construed to affect or modify any right of any retail regulator to

"(1) determine retail electric rates, except as provided by subsection (j);

"(2) develop and implement plans and programs for conservation at the retail level;

"(3) make energy facility siting decisions, including, but not limited to, determining the need for a particular facility, evaluating alternative sites, and considering alternative methods of meeting the determined need; or

"(4) perform any other function permitted by federal, state or local law.

"Sec. 15007. **DEFINITIONS**

"(a) When used in this Act, unless the context otherwise requires --

"(1) "Retail regulator" shall mean all state and local bodies with authority over the rates charged for the retail sale of electric energy.

"(2) "Utility company" shall mean an electric utility company as defined by section 79b(a)(3) of title 15.

"(3) "Operating subsidiary" shall mean an electric utility company making retail sales of electric energy, which is a subsidiary company or affiliate company of a registered holding company.

"(4) "Registered holding company" shall mean a utility holding company registered with the Securities and

Exchange Commission pursuant to section 79e of title 15.

"(5) "Wholesale subsidiary" shall mean a subsidiary of a registered holding company, not an operating subsidiary, which generates or purchases electric energy for resale to the operating subsidiaries."

APPENDIX B

The Council
City of New Orleans

JOSEPH I. GIARRUSSO
Councilmember at Large

DOROTHY MAE TAYLOR
Councilmember at Large

PEGGY WILSON
Councilmember District "A"

JIM SINGLETON
Councilmember District "B"

JACQUELYN BRECHTEL CLARKSON
Councilmember District "C"

LAMBERT C. BOISSIERE, JR.
Councilmember District "D"

JOHNNY JACKSON, JR
Councilmember District "E"

January 24, 1991

The Honorable Mike Synar
Chairman
Subcommittee on Environment,
Energy and Natural Resources
House Government Operations
Committee
B371-B&C Rayburn House Office Building
Washington, D. C. 20515

Dear Congressman Synar:

We are writing today to express our concern about a "bureaucratic shell game" played by two federal agencies -- the Federal Energy Regulatory Commission ("FERC") and the Securities and Exchange Commission ("SEC") -- that has resulted in harm to millions of electricity consumers. Customers of the Entergy holding company system, which operates in New Orleans, other parts of Louisiana, Mississippi and Arkansas, have been aggrieved as a result of a recent transaction which, for all intents and purposes, neither FERC nor the SEC examined.

Entergy has "spun-off" two valuable generating facilities located in Arkansas into a new subsidiary, Entergy Power, Inc. ("EPI"), which intends to use the facilities to sell power to non-affiliates at market-based rates. While the Arkansas Commission, the only retail regulator with state jurisdiction over the two facilities, approved the spin-off, the three jurisdictions which figure to be harmed, New Orleans, Mississippi and Louisiana, were left without any means of review, even though consumers in their states have shared the cost-responsibility for these facilities and benefit from them.

These three regulators took their protests to FERC and the SEC, the two federal commissions with authority over the spin-off. However, rather than examining the transaction's effects on consumers, both agencies punted. FERC acted first, disclaiming jurisdiction over the spin-off and directing the parties to obtain relief at the Arkansas Commission and the SEC. Thereafter, the SEC extended its approval and refused to examine the impact of the transaction on system consumers. That commission suggested that FERC should consider the rate issues. Entergy, itself, attempted to "play-off" the two commission's against each other, arguing to the SEC that FERC is the proper forum to address the protests to the arrangement and to FERC that the SEC decision estops FERC from acting.

Meanwhile, New Orleans has filed a second complaint at FERC requesting review of the wholesale rate impact of the spin-off. However, even though the transaction and New Orleans' concerns have been before the Commission for more than fourteen months, FERC has, to date, failed to act. Instead, Chairman Allday has publicly identified the Entergy spin-off as a model for future utility action in the competitive wholesale generation market.

Given this history, we believe that the process has failed. Instead of federal review of a transaction with significant impact in a multistate context, we have seen a "shell game" where consumers have been left unprotected as the Entergy spin-off is shuttled from one commission to the other without ever being examined.

Both the FERC and SEC decision have been appealed to the United State Court of Appeals for the District of Columbia Circuit, where we hope the Court will require at least one commission to set the matter for a hearing. However, we wanted to make your Committee aware of this situation and hope to work with you in addressing this issue of national importance. For, if this problem is not alleviated, we may be seeing the spin-off become a popular instrument to create additional profits for utility investors at the expense of consumers.

Sincerely,

Joseph I. Giarrusso
City Council President

Dorothy Mae Taylor
Dorothy Mae Taylor
Councilwoman-at-Large

Peggy Wilson
Peggy Wilson
Councilman, District "A"

Jim Singleton
Councilman, District "B"

Jacquelyn Clarkson
Jacquelyn Clarkson
Councilman, District "C"

Lambert C. Boissiere, Jr.
Councilman, District "D"

Johnny Jackson Jr.
Johnny Jackson, Jr.
Councilman, District "E"

CUR 91-61L-1

The CHAIRMAN. Thank you very much, Mr. Giarrusso.

Next, we will hear from Patricia M. Eckert, President of the California Public Utilities Commission.

STATEMENT OF PATRICIA M. ECKERT, PRESIDENT, CALIFORNIA PUBLIC UTILITIES COMMISSION

Ms. ECKERT. Good afternoon, Mr. Chair. I am privileged to testify before you today and before the committee on title XV of your bill, S. 341. I would like to add to those congratulations you have already received to you and your staff for the leadership you have demonstrated in PUHCA reform.

Our commission has not yet taken a formal position on S. 341 nor on S. 570 introduced on behalf of the administration, but I wish to applaud the efforts of you and the administration to develop a national energy strategy. I support the substance of S. 341's title XV, but with a few modifications.

The California Public Utilities Commission is an innovator in designing methods to create greater competition in the wholesale power markets. We are highly supportive of the efforts to allow greater competition in wholesale power markets. The independent producers can potentially offer energy at lower prices than utilities can achieve through building their own generation or from purchasing bulk power from other utilities.

But the States must retain the option to permit utilities to build their own power plants as part of the assessment of the most prudent generating sources for a given State. Independent power producers can and often do perform better than utilities in producing energy in a more cost-effective manner. Additional benefits accrue to consumers and society as a whole due to the production of energy in an environmentally sound manner.

Considering all of the available options for generating sources will result in lower capital costs for new generating capacity, a broad range of generating technology, improved generating efficiencies, and lowered risks to consumers for cost overruns for new generating capacity. The ultimate result is lower electricity prices.

Our commission has observed a shift in regulatory emphasis to more competitive markets coupled with increased oversight powers of State and Federal laws since the Public Utility Holding Company Act of 1935 was enacted. Certain reform of PUHCA is a necessary step to enhance the evolution of the wholesale power markets. We believe that California is on the leading edge of what we refer to as "nonprice" bidding concepts which identify the best bidder to serve all consumer interests, not necessarily just the lowest price bidder.

But to prevent utilities from exercising a de facto veto of competitive bidding, title XV's opt-out declaration provision should be eliminated, in our view.

The CHAIRMAN. Can I get you to stop right there? We have another roll call vote, and I will be back as soon as I can.

[Recess.]

Senator MURKOWSKI [presiding]. In the interest of accommodating our witnesses, I would call the committee back to order. And I believe Ms. Eckert was the witness. And Senator Johnston, I am sure, will be back very soon; he is voting. We had back-to-back votes, and I stayed back-to-back and he tried to work the odds. And clearly it did not work because the votes were back to back.

So with that profound observation, Patricia, would you proceed?

Ms. **Eckert**. Thank you, certainly.

Bidding assures an equitable marketplace in which all types of generating sources compete. Ultimately, the market decides through bidding for resources. Those bid components which society values most—and in some cases whether to avoid some types of generation. In order for this process to evolve, reform of PUHCA is essential.

Reform will also produce increased investment opportunities in the global market, and the export of goods and services by America's electric supply industry.

Under current PUHCA strictures, development of independent power generation has not been prevented completely. Creative ownership arrangements have resulted in some development of IPP's without subjecting the owners to PUHCA regulation.

But PUHCA provisions do bar development of more than one nonqualifying facility, generating unit by a single corporate entity. And PUHCA has impeded large-scale development of multiple generating units by a single owner, such as a utility.

Whether such large-scale development is necessary to meet California energy needs will eventually be determined by market forces. It is interesting to observe that California has no non-QF independent power producers at this time. So our market cannot act as efficiently as it might.

I support added safeguards in title XV to provide ratepayers protection from the increased level of affiliate transactions which will inevitably result from PUHCA reform. Our commission's power to review wholesale power purchasing decisions is vital to California's ability to exercise appropriate oversight of our partially competitive markets.

The authority is crucial to ensure that only reasonable expenses are included in retail electric rates charged to California ratepayers. The National Association of Regulatory Utility Commissioners reviewed earlier PUHCA reform legislation and determined that its savings provision was inadequate, and did not address the potential preemptive scope of FERC decisions approving rates for IPP's.

The present title XV contains a savings provision. I agree that the savings clause provides little in the way of reassurance to States, since it reserves to the States only "such powers as State regulatory authority may have."

For that reason I support the four provisions in the 1989 NARUC resolution on Reform of the Public Utility Holding Company Act.

The jurisdictional authority of the States to review wholesale purchases for prudence must be clarified and affirmed by Congress as PUHCA reform occurs. Our commission's authority to review wholesale power purchasing decisions and administration of wholesale power contracts will become increasingly critical if utilities are allowed to purchase wholesale power from their own affiliates.

The commission firmly believes that it is not preempted under the Federal Power Act from review of utility's prudence when purchasing wholesale power at rates approved by the FERC, as contrasted to the utilities or other choices for cheaper power. This is the essence of the Pike County doctrine.

However, the Supreme Court has not yet ruled on its validity. The recent Supreme Court Mississippi Power and Light decision contains broad dicta concerning the preemptive effect of the Federal Power Act on the State's ability to review the prudence of utility wholesale power purchases.

Based on this decision, San Diego Gas and Electric has challenged our State's commission's authority to review wholesale power purchases over the southwest power link, and our right to disallow imprudently incurred costs from the retail rates.

Thus, even outside of the context of the multi-state holding company, where FERC has set the wholesale power rate and allocation of power among multistate subsidiaries, Mississippi Power and Light has resulted in claims that the Federal Power Act bars a State regulatory body from review of the prudence of wholesale purchasing decisions.

Therefore, PUHCA reform must be premised on legislation ensuring the right of each State commission to review the prudence of wholesale purchasing practices of each distribution utility subject to its authority.

Absent jurisdictional preemption, our commission exercises broad powers to regulate purchasing relationships between a utility and its subsidiary or affiliate. We review all such transactions to determine whether or not it is reasonable for the ratepayers to pay these costs.

When we find the utility conducted itself imprudently or unreasonably, we can and we do disallow costs. This ensures that utility shareholders, rather than the ratepayers bear the financial consequences of imprudent or unreasonable decisions by the utility.

California law gives us this power under our broad authority to set just and reasonable utility rates. Our commission has, in fact, adopted disallowances for purchase power cost between California utilities and their subsidiaries. We have severely limited the dividends accruing to a holding company when it is milking a subsidiary's retained earnings.

California law also prohibits utilities from issuing stocks and bonds for nonutility or affiliate purposes. This empowers us to prevent many financial problems which might otherwise arise.

It is important to keep in mind, however, the California legislation is more empowering in some cases than the laws of other States. The issues of buy-sell arrangements between affiliates has been a problem for decades. The problem does not arise just in the area of independent power production. This is one reason that our commission already has the tools to control these problems. We can require competitive bidding, prohibit transactions outright, impute reasonable costs if abuses have occurred. But first, we have to uncover those abuses.

We also have the broad authority to examine financial and other records of affiliates. Our statute empowers us to review any entity's financial information deemed necessary to evaluate the appropriateness of a regulated, California utilities transaction, with an affiliate, wherever located.

Our commission has the power and the tools to audit and reform affiliate self-dealing, cross-subsidies, and other potential abuses. But one other important factor must be considered. That is the enormous burden that the PUHCA exemption for electric wholesale generators will place on State commissions.

One can reasonably anticipate that once PUHCA restrictions are eased, the number of transactions to be audited will skyrocket. Discovering the abuses will take an enormous number of hours of regulatory time, scores of staff, and increased enforcement budgets. So we must formulate the practical ability to use our regulatory goals in order to achieve our mutual goals.

In conclusion, I support reform of the Public Utility Holding Company Act. But the reform must affirm the State's power to review the prudence of wholesale power purchases at rates set by FERC. When coupled with the proper regulatory oversight, the results will be increased efficiencies for the utilities and independent power producers, lower costs for the consumer, and a sounder environment.

I urge the passage of title XV of S. 341 with the modifications I have recommended here. Thank you for the opportunity to speak to you.

[The prepared statement of Ms. Eckert follows:]

Testimony of Patricia M. Eckert, President, California Public Utilities Commission before Senate Committee on Energy and Natural Resources.

Good afternoon. I am Patricia Eckert, President of the California Public Utilities Commission. I am privileged to testify before you on Title XV of Senator Johnston's bill, S. 341. The California Public Utilities Commission regulates some of the nation's largest utilities which are not affiliated with registered holding companies. While our Commission has not yet taken a formal position on either S. 341 or S. 570 (introduced on behalf of the administration), I applaud the efforts of both the administration and Senator Johnston to develop a National Energy Strategy. I support the substance of S. 341's Title XV, with a few modifications.

I. PUHCA Reform Is Directed to Enhanced Competition in Wholesale Power Markets

The California Public Utilities Commission is an innovator in designing methods to create greater competition in wholesale power markets. We are highly supportive of efforts to allow greater competition in these markets. Independent power producers (IPPs) can potentially offer energy at lower prices than utilities can achieve through building their own generation or from purchasing bulk power from other utilities. But, states still must retain the option to permit utilities to build their own power plants as part of the assessment of the most prudent generating sources for a given state. Independent power producers can, and often do, perform better than utilities in producing energy in a more cost-effective manner. Additional benefits accrue to consumers and society as a whole due to the production of energy in an environmentally sound manner. Consideration of all available options for generating sources will result in lower capital costs for new generating capacity, a broad range of generating technologies, improved generating efficiencies and reduced risks to consumers of cost overruns for new generating capacity. The ultimate result is lower electricity prices.

Our Commission has observed a shift in regulatory emphasis to more competitive markets coupled with increased oversight powers under state and federal laws since the Public Utility Holding Company Act of 1935 was enacted. Certain reform of the Public Utility Holding Company Act (PUHCA) is a necessary step to enhance the evolution of wholesale power markets. We believe California is on the leading edge in "non-price bidding" concepts which identify the best bidder to serve all consumer interests not necessarily just the lowest price bidder. But, to prevent utilities from exercising a de facto veto of competitive bidding, Title XV's "opt-out" declaration provision should be eliminated.

Bidding assures an equitable marketplace in which all types of generating sources compete. Ultimately the market decides, through bidding for resources, those bid components which society values most and, in some cases, whether to avoid some types of generation. In order for this process to evolve, reform of PUHCA is essential. Reform will also produce increased investment opportunities in the global market and the export of goods and services by America's electric supply industry.

Under current PUHCA strictures, development of independent power generation has not been prevented completely. Creative ownership arrangements have resulted in some development of IPPs without subjecting the owners to PUHCA regulation. But, PUHCA provisions do bar development of more than one non-qualifying facility (QF) generating unit by a single corporate entity. And, PUHCA has impeded large scale development of multiple generating units by a single owner, such as a utility. Whether such large scale development is necessary to meet California energy needs will eventually be determined by market forces. It is interesting to observe that California has no non-QF independent power producers at this time. So, our market cannot act as efficiently as it might.

II. PUHCA Reform Must Protect the Rights of State Commissions To Exercise Effective Oversight of Retail Rates

I support added safeguards in Title XV to provide ratepayers protection from the increased level of affiliate transactions which will inevitably result from PUHCA reform. Our Commission's power to review wholesale power purchasing decisions is vital to California's ability to exercise appropriate oversight of our partially competitive markets. This authority is crucial to ensure that only reasonable expenses are included in retail electric rates charged to California ratepayers. The National Association of Regulatory Utility Commissioners (NARUC) reviewed earlier PUHCA reform legislation and determined that its "savings provision" was inadequate and did not address the potential preemptive scope of FERC decisions approving rates for IPPs. Present Title XV contains this "savings provision". I agree that the "savings clause" provides little in the way of reassurance to the states, since it reserves to the states only "such power as a State regulatory authority may have." For that reason, I support the four provisions in the 1989 NARUC "Resolution on Reform of the Public Utility Holding Company Act" as well as the recent NARUC "Resolution Endorsing Legislation to Amend the Federal Power Act to Reform State/Federal Jurisdiction". Copies of these resolutions are appended to my testimony.

The jurisdictional authority of the states to review wholesale purchases for prudence must be clarified and affirmed by Congress as PUHCA reform occurs. Our Commission's authority to review wholesale power purchasing decisions and administration of wholesale power contracts will be increasingly critical if utilities are allowed to purchase wholesale power from their own affiliates. The Commission firmly believes that it is not preempted under the Federal Power Act from review of utilities' prudence when purchasing wholesale power at rates approved by the FERC as contrasted to the utilities' other choices for cheaper power. This is the essence of the Pike County doctrine. However, the Supreme Court has not yet ruled on its validity.

The recent Supreme Court Mississippi Power & Light decision contains broad dicta concerning the preemptive effect of the Federal Power Act on the states' ability to review the prudence of utility wholesale power purchases. Based on this decision, San Diego Gas & Electric Company has challenged our state commission's authority to review wholesale purchases over the Southwest Powerlink and our right to disallow imprudently incurred costs from retail rates. Thus, even outside of the context of the multistate holding company, where FERC has set the wholesale power rate and the allocation of power among multistate subsidiaries, Mississippi Power & Light has resulted in claims that the

Federal Power Act bars a state regulatory body from review of the prudence of wholesale purchasing decisions. Therefore, PUHCA reform MUST be premised on legislation ensuring the right of each state commission to review the prudence of the wholesale purchasing practices of each distribution utility subject to its authority.

III. State Commissions Possess The Power To Police Affiliate Transactions

Absent jurisdictional preemption, our Commission exercises broad powers to regulate purchasing relationships between a utility and its subsidiary or affiliate. We review all such transactions to determine whether or not it is reasonable for the ratepayers to pay the costs. When we find the utility conducted itself imprudently or unreasonably, we can and we do disallow costs. This ensures that utility shareholders, rather than ratepayers, bear the financial consequences of imprudent or unreasonable decisions by the utility. California law gives us this power under our broad authority to set just and reasonable utility rates.

Our Commission has, in fact, adopted disallowances for purchased power costs between California utilities and their subsidiaries. We have severely limited the dividends accruing to a holding company when it is "milking" a subsidiary's retained earnings. California law also prohibits the utilities from issuing stocks and bonds for nonutility or affiliate purposes. This empowers us to prevent many financial problems which could arise. It is important to keep in mind, however, that California legislation is more empowering than laws of many other states.

The issue of buy-sell arrangements between affiliates has been a problem for decades. The problem does not arise just in the area of independent power production. This is one reason that our Commission already has tools to control the problem. We can require competitive bidding, prohibit transactions outright, and impute reasonable costs if abuses have occurred. But first, we must uncover the abuses.

We also have broad authority to examine financial and other records of affiliates. Our statute empowers us to review any entity's financial information deemed necessary to evaluate the appropriateness of a regulated California utility's transaction with any affiliate, wherever located.

Our Commission has the power and the tools to audit and reform affiliate self-dealing, cross-subsidies and other potential abuses. But one other important factor must be considered. That is the enormous burden that the PUHCA exemption for electric wholesale generators will place on state commissions. One can reasonably anticipate that, once PUHCA restrictions are eased, the number of transactions to be audited will skyrocket. Discovering the abuses will take an enormous number of hours of regulatory time, scores of staff and increased enforcement budgets. So we must formulate the practical ability to use our regulatory tools in order to achieve our mutual goals.

IV. I Conclude Reasoned Reform Is Essential

In conclusion, I support reform of the Public Utility Holding Company Act. But, the reform must affirm states' powers to review the prudence of wholesale power purchases at rates set by FERC. When coupled with proper regulatory oversight, the results will be increased efficiencies for the utilities and independent power producers, lower costs for consumers and a sounder environment. I urge the passage of Title XV of S. 341 with the modifications I have recommended.

Resolution on Reform of the Public Utility Holding Company Act

WHEREAS, *Legislation is pending before the Senate Committee on Energy and Natural Resources, S. 406, to amend the Public Utility Holding Company Act of 1935 (PUHCA); and*

WHEREAS, *The legislation would create a new category of electric generator called Exempt Wholesale Generators (EWGs) which would not be subject to the regulatory restrictions imposed on holding companies by PUHCA; and*

WHEREAS, *The purpose of this bill is to greatly reduce the barriers to entry for holding companies, including electric utilities, to enter wholesale markets and sell power to distribution utilities for resale to consumers; and*

WHEREAS, *The addition of new EWGs to wholesale markets subject to regulation by the Federal Energy Regulatory Commission (FERC) will erode State control of an increasingly large percentage of the cost of electrical service, particularly if the FERC and the Federal Courts continue to hold, in reliance on Mississippi Power & Light v. Mississippi ex rel. Moore, 487 U.S. ___ (1988), that State commissions have severely limited jurisdiction to review the passthrough of purchased power costs in retail rates; and*

WHEREAS, *By permitting unrestricted utility ownership of EWGs, the legislation creates the opportunity for utilities to cross-subsidize their construction and operation of wholesale power facilities through their retail distribution rates, particularly utilities owning and operating EWGs which sell power to affiliated distribution companies; and*

WHEREAS, *The substance of this Resolution is reflected by the Resolution of the same Title adopted by the NARUC Executive Committee on July 27, 1989; now, therefore, be it*

RESOLVED, *That the National Association of Regulatory Utility Commissioners (NARUC), convened in its 101st Annual Convention in Boston, Massachusetts, strongly opposes amendment to the Public Utility Holding Company Act of 1935 unless provisions are included which specifically preserve the legal authority of the respective State commissions to insure that the sale of power by new entrants into wholesale markets is in the interest of retail ratepayers. Such provisions must:*

(1) Ensure the right of each State commission to review the prudence of the wholesale purchasing practices of each distribution utility subject to the State commission's authority; and

(2) Preserve the right of each State commission to conduct bidding programs

and least cost planning; to determine the appropriate mix of generation, as a matter of fuel and technology choice and as a matter of ownership; to take actions to insure system reliability; to restrict or prohibit affiliate transactions; and to approve or disapprove the transfer of assets from a utility to another party, free from preemption under Federal statutes or the Commerce Clause; and

(3) *Provide a right of access, enabling State commissions to review the books and records of holding companies and all holding company subsidiaries, including non-regulated businesses that transact business with the retail distribution company or EWG entity; and*

(4) *In the case of an integrated multi-State utility holding company, authorize regional compacts for those States who have jurisdiction over retail subsidiaries of the holding company for the sole purpose of regulating the allocation of costs and/or the prudence of wholesale power purchases by the holding company.*

Sponsored by the Committees on Electricity, Energy Conservation, and Finance and Technology
Adopted November 15, 1989

Resolution Endorsing Legislation to Amend the Federal Power Act to Reform State/Federal Jurisdiction

WHEREAS, *In enacting the Federal Power Act in 1935, Congress granted the Federal Power Commission, predecessor to the Federal Energy Regulatory Commission (FERC), jurisdiction to regulate the wholesale sale and transmission of electricity in interstate commerce while preserving State jurisdiction over local rates and services of utilities; and*

WHEREAS, *In 1964, the U.S. Supreme Court held in Federal Power Commission v. Southern California Edison Co., 376 U.S. 205 (1964) (the Colton case) that Federal jurisdiction over wholesale sales included entirely intrastate wholesale transactions, thereby extinguishing State intrastate wholesale authority; and*

WHEREAS, *In a series of decisions culminating in its decision in Mississippi Power & Light v. Mississippi ex rel. Moore, 487 U.S. 354 (1988), the Supreme Court has sharply restricted the authority of the States to regulate the passthrough in retail rates of a utility's FERC-regulated costs of power purchased at wholesale; and*

WHEREAS, *Despite these decisions, the bulk of electric power costs and rates are determined by State regulatory commissions, including the costs of facilities used to provide wholesale sales and transmission service for which FERC establishes rates and conditions of service. Moreover, States retain exclusive jurisdiction over the siting of transmission facilities used for both inter and intrastate service; and*

WHEREAS, *In recent years, the electric utility industry has undergone substantial change as a result of increased reliance on wholesale power suppliers, including non-utility generators, greater regional coordination of power supply planning and operations, mergers and consolidations of utility operations in multiple jurisdictions, and increased transmission access by third parties. As a result, the FPA's jurisdictional allocation of authority is no longer consistent with the manner in which the industry now operates; now, therefore, be it*

RESOLVED, *That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), convened at its Winter Committee Meeting in Washington, D.C., hereby calls upon Congress to amend the Federal Power Act in order to reform State and Federal jurisdiction over electric utility transactions to conform to the operational reality of the industry; and be it further*

RESOLVED, *That such amendments to the Federal Power Act be based upon the following principles:*

1. *Jurisdiction over the retail rates and services of electric utilities shall remain with the States. Such jurisdiction must be strengthened to affirm the authority of the States to regulate the passthrough of purchased power costs in the retail rates of utilities;*

2. Jurisdiction over intrastate wholesale sales and transmission rates, terms and conditions should be returned to the State regulatory commissions;

3. Jurisdiction over multistate transactions (including system cost allocation, bulk power purchases and sales, emission allowance allocations, and use of transmission facilities) within registered holding company systems operating should be lodged in regional regulatory bodies authorized by Congress and established on a purely voluntary basis by the States in which the systems operate. In the event such regional bodies are not formed, or if formed, decline to regulate given issues, jurisdiction shall be lodged in the FERC except to the extent the electric utility subsidiaries of such holding companies are exempt from FERC jurisdiction over such issues pursuant to Section 201 of the Federal Power Act, 16 U.S.C. sec. 824, or successor provision(s). Jurisdiction over multistate transactions of other utility systems should also be exercised by such voluntarily-established regional bodies, but without default to FERC.

4. Congress should authorize the creation of multistate compacts consistent with basic principles of administrative efficiency and fairness. States which voluntarily form such compacts would collectively determine rules of governance and internal procedures; and be it further

RESOLVED, *That the following principles govern the siting of transmission facilities to be used in multistate transactions:*

1. States exercising jurisdiction over the siting and certification of transmission facilities should not discriminate against interstate facilities, meaning that interstate facilities should be sited, certificated, and otherwise regulated under the same standards and procedures as intrastate facilities.

2. States should retain jurisdiction to make all factual determinations concerning transmission siting. Judicial review of such determinations, whether in State or Federal courts, should not be de novo, assuming the States have conducted evidentiary proceedings.

3. Congress should authorize the creation of multistate compacts which permit willing States to:

   a. Identify regional bulk power market needs for State siting agencies to consider in their respective deliberations; and

   b. Plan for the construction of new interstate transmission facilities;

4. Congress should further authorize the creation of multistate compacts which permit willing States in which an interstate transmission facility is proposed to be sited:

a. To issue certificates authorizing the construction of the proposed facility; or

b. If States choose to retain certification authority for themselves, to agree upon and employ a mechanism for a final, binding resolution of a proposed facility siting when the individual States involved have come to conflicting and/or inconsistent determinations in their respective deliberations.

Sponsored by the Committee on Electricity
Adopted February 27, 1991

The **Chairman** [presiding]. Thank you, Ms. Eckert.

Next, Charles A. Patrizia, representing the Registered Electric Utility Holding Companies.

STATEMENT OF CHARLES A. PATRIZIA, ON BEHALF OF THE REGISTERED ELECTRIC UTILITY HOLDING COMPANIES

Mr. **Patrizia**. Thank you, Mr. Chairman.

My name is Charles Patrizia, and I am very pleased to have this opportunity to testify today on the issues of particular importance to the registered electric utility holding companies raised by title XV of S. 341.

I have prepared testimony that I have submitted, and I would request, Mr. Chairman, that that be made a part of the record.

The **Chairman**. It will be.

Mr. **Patrizia**. I am testifying on behalf of an ad hoc group of eight registered electric utility holding companies. These eight utility holding companies, through their operating and service company affiliates, serve over 12.5 million customers in 21 States, account for approximately 13.5 percent of the total electricity generation capacity of the United States, and have over 90,000 employees.

In 1935, to correct abuses among electric utility holding companies—including pyramiding, deceptive financial practices, and inadequate State regulatory structures—Congress enacted the Public Utility Holding Company Act of 1935. The 1935 act granted pervasive regulatory jurisdiction over financial aspects of the utility holding companies to the Securities and Exchange Commission, and mandated continuing SEC oversight.

As part of the same series of enactments, Congress also granted to the Federal Power Commission, the predecessor agency to the Federal Energy Regulatory Commission, the authority to regulate wholesale and interstate transactions in capacity and energy.

At the time of PUHCA's enactment, there were over 200 utility holding companies. Today, only nine registered electric utility companies remain—I would add that there area about 90 exempt companies.

And in accordance with PUHCA's original goals, they are highly integrated, electric utility systems. They pool reserves, they coordinate the construction of generating units, they coordinate scheduled maintenance, and they centrally dispatch the generating system's facilities within the system.

As a result, the registered holding companies provide numerous benefits to investors, to consumers, and to the general public, with the most important benefit being the provision of cost-effective electric energy to more than 12.5 million residential, industrial, and commercial consumers.

As the companies most affected by the Holding Company Act, and given our expertise in the design, engineering, and operation of generating facilities, the registered companies would view with great concern any legislation that purports to encourage competition in the wholesale generation market—but effectively would prevent the registered companies from engaging as equals with other utilities and nonutility developers, in the development of new generation sources.

Congress, of course, must answer the question of whether the National Energy Policy requires changes to the 1935 act. The registered holding companies, like the utility industry generally, hold different views on the need for new corporate structures to encourage the construction of generation facilities.

The registered companies are united, however, behind several principles with respect to any amendments that would alter the requirements of the 1935 act. These three principles are: first, if the Holding Company Act is to be amended, all types of entities must be able to participate on the same basis. We appreciate the effort the chairman has made in drafting S. 341 in that regard. But we do have some questions that still remain, on that score, Mr. Chairman.

Second, transmission access is not a 1935 act issue and should not be part of this debate.

Third, regulatory burdens and uncertainties should not be increased, and certainly should not be increased only for some. Recognition of these principles is essential to a bill that would accomplish its intent of fostering greater competition in the generation sector.

Let me now go into a little bit more details on these views. First, that all types of entities must be able to participate on an equal basis. If the policy debate before Congress is resolved in favor of revising the act, to encourage the formation of electric wholesale generators, the registered companies would unite in opposing any bill that would exclude registered companies from participation in this field, or would free other kinds of companies from the 1935 act's burdens with respect to EWG's, but continue to subject the registered companies to all of the 1935 act's burdens. Either outcome would leave the registered companies unable to compete on an equal footing.

In this regard, we appreciate the approach adopted in S. 341. It seeks to allow registered companies to own EWG's on an equal basis, while retaining the existing regulatory structure with respect to other aspects of the registered companies.

To ensure that registered companies are permitted to compete on an equal basis, we would ask Congress to consider explicitly providing that at least limited security or guarantee issuances by a registered company to finance an EWG would not require prior SEC approval. That is an issue, Mr. Chairman, that was discussed this morning with Mr. Fleischman from the Securities and Exchange Commission. We appreciated his response indicating that the Commission might look favorably on some of these things, but really believe that we need some additional certainty in that regard. We will be happy to work with the staff and with the commission in trying to review those sorts of provisions.

Second, we ask Congress to consider explicitly stating that registered holding companies should be permitted to finance EWG's without regard to the SEC mandated debt-equity ratios currently established for the registered companies. Again, that issue was discussed with Mr. Fleischman this morning. Again, we would be happy to work with staff and with the commission in trying to address those issues.

The second principle that we had is that transmission access is not a 1935 act issue. We are very appreciative of your statement this morning, Mr. Chairman, noting that transmission is not an issue which is on the table. We were very appreciative of that. Because under the 1935 act, the registered companies are required to inter-connect their affiliate generation facilities, so as to be capable of integrated operation. Proper use of transmission capacity is the key to operation and dispatch of our inter-connected facilities. Control and use of transmission systems are essential to reliability, and to economic operation of a centrally dispatched system.

For these reasons we believe that transmission access is not properly addressed in the context of amendments to the 1935 act. The FERC is currently reviewing and acting upon the issue of transmission access. There are many significant proposals and developments underway.

We believe that Congress should give time for that process to evolve and allow FERC, the regulatory agency with the greatest expertise in this area, the room to address these issues.

We believe the administration's recently proposed National Energy Strategy properly recommends that legislative action should be pursued, only if it is clearly established that FERC's authority and its ongoing regulatory efforts prove to be inadequate.

Third, regulatory burdens and uncertainties should not be increased. Proponents have urged that amending the 1935 act will encourage greater competition in the generating sector, and that that competition will bring more economic and reliable service. The goals of more economic and reliable service, however, will be defeated if the amendments increase regulatory burdens, or engender greater regulatory uncertainty. This is particularly true if only some of the participants in the market are subject to increased regulatory burdens, or increased uncertainty.

The existing regulatory structures and divisions of authority have been the subject of consistent agency and court interpretation. That framework is well understood, and the burdens for those utilities, considering the purchase from an EWG are known. In enacting the Holding Company Act and the Federal Power Act, Congress established a specific jurisdictional scheme under which the SEC would retain control and oversight over the financial and securities markets aspects of a multistate holding company. And the States would regulate the affiliates.

Likewise, the Federal Power Commission, now FERC, would regulate the sales of electricity and interstate commerce at wholesale, to distributing companies, and States would regulate the retail sales to ultimate consumers.

For the last 50 years, when the sale of energy at wholesale and interstate commerce, or the regulation of multistate holding companies is at issue, only a neutral, Federal, administrative forum has been appropriate. Likewise, if the interest is a rate for sales of energy at retail to ultimate consumers, the individual State regulatory agency is the most appropriate forum.

The current legislation to encourage EWG's does not change that basic analysis. There is no need for drastic restructuring, simply because some feel that FERC and the SEC have decided cases differently than some State commissions would have preferred. Moreover, the portrayal of FERC as a woefully inadequate regulatory body, or a safe harbor in regulating multistate companies is not borne out by the commission's record, or the experience of the holding companies in proceedings before the commission.

In the case of multistate holding companies, and agreements for wholesale rates impacting on several States, consumers overall will suffer if a neutral, Federal forum is not available. Agreements that increase efficient operation—from simple pooling arrangements, to registered electric utility holding company system agreements—create an overall benefit to consumers of all the utilities, because the individual utilities agree to subordinate their interests, to those of the integrated pool.

State commissions necessarily focus on the costs and benefits to their jurisdictional customers only. As long as pooling arrangements exist, and their mutual benefits are to be shared, overall control and regulation must be in the hands of a neutral, Federal administrative agency.

Some have advocated the creation of a regional regulatory board as an alternative to FERC. There are a number of potential problems with using such a regulatory authority, and including that kind of provision will make it likely that there will be further delay, further uncertainty, and less predictability in reviewing EWG purchase agreements.

The registered companies also oppose codification of a Pike County holding, because codification could work substantial mischief for the registered companies which must operate as a single, integrated system.

Holding company affiliates operate within a pool, and lack the free choice among sources of power that is the underlying premise of Pike County.

Codifying the holding in Pike County would effectively stifle the development of the independent generation sector, especially in selling to utilities operating as integrated pools because of the risks associated with the purchase from an EWG.

PUHCA reform and the creation of EWG's does not alter the interests at issue, or the need to restructure the locus of the decision-making authority. The current framework as interpreted by the courts, and applied by Federal and State regulatory authorities has provided and continues to provide adequate safeguards to the American consumer, and the existence of EWG's will not affect this careful balance between State and Federal interests.

Mr. Chairman, I thank you very much for the opportunity to appear today. I will be very happy to respond to questions.

[The prepared statement of Mr. Patrizia follows:]

TESTIMONY OF

CHARLES A. PATRIZIA

on behalf of

An Ad-Hoc Group of Registered
Electric Utility Holding Companies

before the

SENATE ENERGY AND NATURAL
RESOURCES COMMITTEE

March 14, 1991

Mr. Chairman and Members of the Committee:

My name is Charles A. Patrizia and I am very pleased to have this opportunity to testify today on the issues of particular importance to the registered electric utility holding companies raised by Title XV of S. 341.

I. INTRODUCTION

I am testifying on behalf of an ad hoc group of registered electric utility holding companies.[1/] These eight utility holding companies, through their operating and service company affiliates, serve over 12.5 million consumers in 20 States, account for approximately 13.5 percent of the total electricity generation capacity of the United States and have over 90,000 employees.

In 1935, to correct abuses among electric utility holding companies, including pyramiding, deceptive financial practices, and inadequate state regulatory structures, Congress enacted the Public Utility Holding Company Act of

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[1/] This testimony is presented on behalf of Allegheny Power System, Inc., American Electric Power Company, Inc., Central and South West Corporation, Eastern Utilities Associates, General Public Utilities Corporation, New England Electric System, Northeast Utilities, and The Southern Company.

1935 (the "'35 Act" or "PUHCA").[2] The '35 Act was intended to eliminate all utility holding companies whose operations were not geographically and functionally "integrated" and whose continued existence was not in the public interest. The '35 Act granted pervasive regulatory jurisdiction over financial aspects of the utility holding companies to the Securities and Exchange Commission ("SEC") and mandated continuing SEC oversight with respect to diversification, issuance of securities, acquisition or sale of utility assets, expansion and certain transactions among affiliated companies. As part of the same series of enactments, Congress also granted to the Federal Power Commission ("FPC"), the predecessor agency to the Federal Energy Regulatory Commission ("FERC"), the authority to regulate wholesale and interstate transactions in capacity and energy.

At the time of PUHCA's enactment, there were over 200 utility holding companies. Today only nine registered electric utility companies remain[3] and, in accordance with PUHCA's original goals, they are highly integrated electric

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2/ 15 U.S.C. §§ 79 et seq. (1988).

3/ There are also over 90 exempt holding companies. These companies are subject to only limited restrictions under the '35 Act, but remain subject to stringent State controls.

utility systems that pool reserves, coordinate construction of generating units, coordinate scheduled maintenance and centrally dispatch the generating facilities within the system. As a result, the eight registered holding companies I am testifying on behalf of this afternoon provide numerous benefits to investors, consumers and the general public, with the most important benefit the provision of cost-effective, reliable service to over 12.5 million industrial, commercial and residential consumers.

As this Committee considers the issue of carving out an exemption to PUHCA to encourage the formation of Electric Wholesale Generators ("EWGs"), it should consider those changes that are necessary to that goal and the context of the industry. As the companies most affected by PUHCA and given their expertise in the design, engineering and operation of generating facilities, the registered companies would view with great concern any legislation that purports to "encourage competition" in the wholesale generation market but effectively prevents the registered companies from engaging as equals with other utilities and non-utility developers in the development of new generation sources.

II. ESSENTIAL PRINCIPLES IN CONSIDERING AMENDMENTS

Congress must answer the question of whether national energy policy requires changes to the '35 Act. The registered electric holding companies, like the industry generally, hold different views on the need for new corporate structures to encourage construction of generating facilities. This Committee in prior years and this morning has heard concerns about reliability of EWGs and other operating concerns that some utilities have; several registered companies share those concerns. The eight registered companies I represent are united, however, behind three principles with respect to any amendments that would alter the requirements of the '35 Act. These principles are:

1. If PUHCA is to be amended, all types of entities must be able to participate on the same basis.
2. Transmission access is not a '35 Act issue, and should not be part of this debate.
3. Regulatory burdens and uncertainty should not be increased and certainly should not be increased only for some.

Recognition of these principles is essential to a bill that would accomplish its intent of fostering greater competition. Failure to include these principles will make it less likely that EWGs will find a ready market. Let me now turn to additional explanation of our views on each of these principles.

1) If PUHCA is to be amended, all types of entities must be able to participate on the same basis.

As the Committee is aware, the '35 Act imposes stringent limits on those entities which hold defined percentages of voting interests in two or more electric utilities. Congress, however, relaxed these limits to encourage the development of alternative energy resources and to foster competition in the industry under the Public Utility Regulatory Policies Act of 1978 ("PURPA"). The proposed amendment to the '35 Act, like PURPA, is intended to permit a broader range of corporations or corporate structures to develop and own generation facilities.

If the public policy debate before Congress is resolved in favor of revising the '35 Act to encourage the formation of EWGs, the eight registered companies I am testifying on behalf of are united in opposing any bill that would either exclude registered companies from participating in this field or would free other companies from the '35 Act's burdens with respect to EWGs but continue to subject the registered companies to all of the '35 Act's burdens.

Either outcome would leave the registered companies unable to compete on an equal footing and would be wholly unacceptable.

In this regard, we appreciate the approach adopted in S. 341 that seeks to allow registered companies to own EWGs on an equal basis. To ensure registered companies are permitted to compete on an effectively equal footing, we ask that Congress consider (i) explicitly providing that at least limited security or guaranty issuances by a registered company to finance an EWG would not require prior SEC approval, and (ii) explicitly stating that the registered holding companies should be permitted to finance EWGs without regard to the SEC mandated debt/equity ratios currently established for the registered companies.

The EWG industry is expected to be entrepreneurial and fast-moving, and registered companies will be at a competitive disadvantage if they are subject to a regulatory review process that takes several months at a minimum while their competitors can commit funds instantly. At present, the SEC must approve the issuance of securities by a registered holding company and the acquisition of the securities of the EWG subsidiary. While others would be able to form an EWG immediately and without regulatory clearance, under existing requirements a registered company could be delayed and thus be at a substantial competitive disadvantage. Similarly, while others would be able to assist their EWGs in obtaining sufficient working capital or other financing to carry out development of projects through early bidding, design, engineering and permitting phases (before project financing is ordinarily available), registered companies would be subject to SEC approval requirements for issuing securities to provide financing to their subsidiaries. This approval process can take a significant amount of time and be delayed substantially if intervenors object to the SEC granting approval. Thus, Congress should consider providing expressly that a registered company could issue securities with the proceeds invested in the equity of an EWG at least up to some specified percentage of its capital or provide guarantees to an EWG without further SEC action.

Most anticipate that EWG's will be project financed, that is, they will be financed with a more highly leveraged debt financing structure (as much as 95% debt) instead of the more typical utility debt/equity ratio, which averages around 55%/45%. Whether significant leveraging of new generation projects is appropriate is a national policy question Congress should consider in detail. If leveraging to that high extent is appropriate (recognizing that only assets of a particular project would be leveraged and not the entire system), the bill should provide explicitly that registered companies can use these same financing techniques, without being required by the SEC to increase capital in other parts of the company to maintain the required overall ratio. We expect the debt incurred for these projects will have recourse only to project assets, so the core utility system would be unaffected even if a registered company were to encounter difficulty with an EWG leveraged investment. It would be a significant handicap if the registered companies must adjust their capital to maintain an overall ratio while other competitors do not, merely because the EWG uses project financing.

2) Transmission access is not a '35 Act issue.

Under the '35 Act, the registered companies are required to interconnect their affiliate generation facilities, so as to be capable of integrated operation. Proper use of transmission capacity is the key to operation and dispatch of our interconnected facilities. Control and use of the transmission systems are essential to reliability and to economic operation of a centrally dispatched system.

For these reasons, we believe that transmission access is not an issue properly addressed in the context of amendments to the '35 Act. FERC is currently reviewing and acting upon the issue of transmission access, and there are many significant proposals and developments underway. Congress should give time for that process to evolve, and allow FERC, the regulatory agency with the greatest expertise in this area, the room to address these issues. The Administration's recently proposed National Energy Strategy properly recommends that legislative action be pursued only if it is clearly established that FERC's authority and its ongoing regulatory efforts are inadequate to deal with transmission access issues.

In the meantime, the present transmission system allows utilities to deliver reliable energy. The numerous issues raised with respect to "transmission access" do not require a legislative solution today and certainly should not be considered in the context of developing policies relating to construction and ownership of generating facilities.

3) Regulatory burdens and uncertainty should not be increased, and certainly should not be increased only for some.

Those who believe that the '35 Act should be amended to encourage greater competition in the generating sector believe that encouragement of EWGs will result in more economic and reliable service. The goals of more economic and reliable service, however, will be defeated if the amendments also increase regulatory burdens or engender greater regulatory uncertainty. This is particularly true if only some participants in the market are subject to increased regulation or regulatory uncertainty.

For these reasons, if PUHCA is amended to carve out an exemption for EWGs with the goal of encouraging their development, the amendment should focus strictly on that goal, as does S. 341. We are aware that some propose to adorn a PUHCA amendment bill with provisions addressed to other matters that have only a tenuous connection to PUHCA reform. Foremost among these proposals include creating further levels of regulatory review by state utility commissions, regional boards, or similar structures.

The existing regulatory structures and divisions of authority have been the subject of consistent agency and court interpretation and the framework is well understood and predictable. That predictability is an essential part of the ability of power purchasers and sellers to enter into long term contracts. Without that predictability, financing and constructing new generation facilities will be more difficult and costly. Thus, changing those structures would effectively thwart the intended purposes of the amendments by increasing regulatory risks and burdens for those utilities considering a purchase from an EWG.

A. Origin of the "Bright Line" between Federal and State regulation

The primary statutory basis of Federal regulatory authority in the electric power industry is found in PUHCA's companion legislation -- The Federal Power Act of 1935 ("FPA").[4] The impetus for enacting the FPA was the Supreme Court's decision in 1927[5] that a State's attempted regulation of a utility's rates for energy in an interstate sale at wholesale to distributing companies imposed a direct burden upon interstate commerce and is prevented by the Commerce Clause.[6] At the time of the decision in Attleboro, however, the Federal government had not taken any effective steps to regulate this area and, thus, there was a "gap" in the regulatory structure.

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[4] 16 U.S.C. §§ 791a et. seq. (1988).

[5] Public Utils. Comm'n of Rhode Island v. Attleboro Steam & Elec. Co., 273 U.S. 83 (1927).

[6] Id. at 89-90.

As the Supreme Court noted in a subsequent decision, to resolve the problem of the so-called "Attleboro Gap," the FPA expressly granted exclusive jurisdiction over sales of electric power at wholesale in interstate commerce to the Federal government. In enacting PUHCA and the FPA, Congress established a specific jurisdictional scheme under which the SEC would retain control and oversight over the financial and securities markets aspects of the multistate holding companies and States would regulate the affiliates. Likewise, the FPC would regulate sales of electricity in interstate commerce at wholesale to distributing companies and States would regulate retail sales to the ultimate consumers.7/

In general, the FPA has achieved the original goal of establishing a "bright line" between Federal and State jurisdiction over electric power sales. Thus, even if only partially of interstate origin, all sales of electric power

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7/ See, e.g., United States v. Public Utils. Comm'n of California, 345 U.S. 295, 303 (1953).

for resale are subject to exclusive Federal jurisdiction.[8] Likewise, a State regulatory authority has jurisdiction over a direct sale to the ultimate consumer, even if the same is across State borders.[9]

Under well established case law, once a wholesale power rate contract has been accepted by FERC, the rate may not be challenged collaterally in Federal court and State courts and regulatory agencies may not conclude that the filed rate is unreasonable.[10]

B. Codification of the Pike County doctrine would be inappropriate and antithetical to EWG development.

One proposal "codifies" a Pennsylvania state court decision as a means of enhancing state control over wholesale power transactions. This proposal is contrary to the purpose of amending PUHCA to facilitate EWG development and fundamentally misaligns the well established jurisdictional boundaries set forth above.

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[8] Id. at 303.

[9] See Panhandle E. Pipe Line Co. v. Public Serv. Comm'n of Indiana, 332 U.S. 507 (1947) (interpreting the Natural Gas Act).

[10] Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953, 963-64 (1986); Narragansett Elec. Co. v. Burke, 119 R.I. 559, 568, 381 A.2d 1358, 1363 (1977), cert. denied, 435 U.S. 972 (1978).

In Pike County Light and Power Co. v. Pennsylvania Pub. Util. Comm'n,[11/] an intermediate state appellate court held that while the State commission could not set a different rate for the wholesale transaction, it could determine whether it was reasonable for the purchasing utility to have bought the power in light of other alternatives available to it.[12/] The applicability of this decision when FERC has acted has never been determined by the Supreme Court,[13/] and has been adopted in only a few states.

The registered companies oppose codification of the Pike County holding for two reasons. First, codification of Pike County could work substantial mischief for the registered companies, because PUHCA requires each registered holding company system to limit its operation to

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[11/] 77 Pa. Commw. 268, 465 A.2d 735 (1983).

[12/] 77 Pa. Commw. at 271, 465 A.2d at 738-39.

[13/] In Nantahala, Justice O'Connor noted without deciding the issue, that "a particular *quantity* of power procured by a utility from a particular source could be deemed unreasonably excessive if lower-cost power is available elsewhere, even though the higher-cost power actually purchased is at a FERC-approved, and therefore reasonable, *price*." Nantahala, 476 U.S. at 972 (emphasis in original).

"a single integrated public-utility system."[14] In meeting this requirement, registered companies' systems are planned and operated in a highly integrated manner and if necessary, power is purchased to meet the pooled needs of all of the utility subsidiaries of the system. A utility subsidiary within a registered company system, therefore, does not have the free choice among sources of power upon which the holding in Pike County is premised.

Both the Supreme Court and the FERC have recognized that jurisdiction over allocations of new generating units and purchased power among the companies within a registered system must take place at the Federal level.[15] In ruling that a State commission could not disallow costs incurred under an agreement by one company in a registered system to purchase power from an affiliate, FERC noted that Pike County was inapplicable to registered holding company allocations:

> [W]hile we agree that the lack of autonomy on the part of individual members of a registered public-utility holding company system heightens the need for regulatory scrutiny over arrangements [for the purchase and sale of power among them], that

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[14] 15 U.S.C. § 791(b)(1).

[15] Mississippi Power and Light Co. v. Mississippi ex. rel. Moore, 487 U.S. 354, 371-73 (1988); AEP Generating Co. and Kentucky Power Co., 38 FERC ¶ 61,243, modified, 39 FERC ¶ 61,158 (1987).

> scrutiny can only take place at the Federal level. State commissions may intervene and participate in proceedings before this Commission, raising whatever objections they may have. However, they may not disallow the costs of power purchased under arrangements [among holding company affiliates], in retail rate proceedings, by finding that the decision of an individual operating company to enter into the agreement was imprudent.[16]

Similarly, in Mississippi Power, the Supreme Court held that a state commission may not deny an operating subsidiary of a registered holding company system recovery of the cost of the portion of a nuclear unit that was allocated to it by a FERC order. In reaching this conclusion, the Supreme Court noted:

> First, FERC has exclusive authority to determine the reasonableness of wholesale rates. . . . Second, FERC's exclusive jurisdiction applies not only to rates, but also to power allocations that affect wholesale rates. . . . Third, States may not bar regulated utilities from passing through to retail consumers FERC-mandated wholesale rates.[17]

In a concurring opinion, Justice Scalia explained that, in the context of affiliated companies in a registered system, FERC had appropriately exercised jurisdiction "over the prudence of a particular utility's joining a pooling

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16/ 39 FERC at 61,627 (emphasis added).

17/ 487 U.S. at 371-72 (citations omitted).

arrangement."[18] A provision that "codifies" the holding in Pike County as a Federal statute, even if it were otherwise appropriate, therefore, would go well beyond simply codifying an accepted or general principle.

Second, codifying the holding in Pike County would effectively stifle the development of the independent generation sector, especially in selling to utilities operating as integrated pools, because the risks associated with a purchase from an EWG would be greatly increased. A utility would be subject to a significant risk of disallowances if a State commission were to determine, years after the fact, that it should not have entered into a contract to purchase power from an EWG. This risk would provide a significant disincentive to utilities' contracting to purchase power from EWGs. If a utility sought to shift this risk to the EWG through a "regulatory out" clause, it is doubtful that a developer could obtain financing where the contract to sell power could evaporate upon a ruling by a State commission.

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[18] Id. at 380.

C. There is no need to restructure State and Federal regulatory authority

For the last 50 years, when the sale of energy at wholesale in interstate commerce or the regulation of multistate holding companies is at issue, only a neutral Federal administrative forum has been appropriate. Likewise, if the interest is the rate for sales of energy at retail to the ultimate consumers, the individual State regulatory agency is the most appropriate forum. The current legislation to encourage EWGs does not change this basic analysis. There is no need for a drastic restructuring simply because some feel that FERC and the SEC have decided cases differently than some State commissions would have preferred. Moreover, the portrayal of FERC as a woefully inadequate regulatory body and a "safe harbor" in regulating multistate holding companies is not borne out by FERC's record or the experience of the holding companies in proceedings before FERC.

In the case of multistate holding companies and agreements for wholesale rates impacting on several States, consumers overall will suffer if a neutral Federal forum is not available. Agreements that increase efficient operation, from simple pooling arrangements to registered electric utility holding company systems, create an overall benefit to the customers of all the utilities involved because the individual utilities agree to subordinate their interests to those of the integrated system pool. State commissions, however, necessarily focus on costs and benefits to their jurisdictional customers only. As long as pooling arrangements exist and their mutual benefits are to be shared, overall control and regulation must be in the hands of a neutral Federal administrative agency.

Several proposals have been advanced to alter the Federal/State regulatory framework. By discussing these proposals we do not mean to legitimize any aspects of them. States actively participate in FERC proceedings[19] and have significant authorities involving jurisdictional affiliates. An extension of the States' role as envisioned by these proposals for regional regulatory boards ("RRBs") is unnecessary and unworkable.

A variety of proposals for RRBs have been circulated, and, although the specifics of each may vary, in general each envisions a RRB comprised of representatives from each State commission with jurisdiction over operating subsidiaries of the parent holding company.[20] The RRB would have the authority to review initial decisions by the FERC administrative law judge ("ALJ") and the RRB's decision would have the force and effect of the same decision by FERC. There are a number of practical problems, however, with utilizing a regional regulatory approach for multistate holding companies.

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[19] 16 U.S.C. § 825g (1988).

First, RRBs are contrary to the intent of the proposed PUHCA amendments in that creating an additional layer of regulatory scrutiny for a registered company's purchase of power from an EWG would raise a significant additional impediment to purchases. Registered companies will be less likely to purchase power from an EWG where the transaction will require unanimous approval of the affected States. Thus, the RRB's proposal would effectively limit the market for EWGs.

Second, RRB's could make it extremely difficult for registered companies to continue to plan and operate in an integrated manner, as PUHCA requires. All power planning

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20/ See, e.g., Vince, Quirk and Glick, Regional Regulation of Multistate Holding Companies: A Model for Readjusting the Federal-State Boundary, 3 Elec. J. 56 (1990).

decision would be subject to review by a cumbersome ad hoc body that could not act except by unanimous consent. The additional layer of bureaucratic scrutiny will act as drag on the efficient operation of registered systems and subject them to a substantial competitive disadvantage.

Third, each multistate holding company would be regulated by a separate RRB. Several States, however, are served by two or more holding companies. For example, AEP serves seven States and, presumably, all seven States would form a RRB. Allegheny Power System, Inc., however, also serves one of those States as well as two others. Thus, some States might have representatives on two RRBs and potential conflicts between the goals of the different RRBs would not be conducive to certainty in the planning process, consistency in review of a holding company's cost allocations or the construction and purchasing activities of its wholesale subsidiaries.

Finally, a proceeding before an RRB would first be referred to a FERC ALJ, following FERC procedures and precedent, for a fact finding and initial decision. The RRB's review of an initial decision would be substituted for FERC's, on the premise that State representatives are more likely to consider the consumer's interests and understand the regional impact of their decision. This, however, is a flawed premise: a Federal agency not responsible to parochial or local political interests is just as likely, if not more, to fairly consider and balance the interests of the consumer and the shareholder. In addition, unlike the Commission's review of ALJ determinations and the development of a unified body of precedent under the current structure, determinations by the unaffiliated RRBs may result in a "split" among the RRBs that would further decrease consistency and certainty for the holding companies. The RRBs thus make it likely that there will be further delay, further uncertainty and less predictability in reviewing EWG purchase agreements.[21]

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[21] The method by which the members of the RRB would be chosen is also not clear in any of the current proposals. In particular, it is not clear whether the members would represent the State or act independently. This is a particular problem if a State elects to belong to two RRB's and the same members sit on both RRBs. In addition, because the RRB representatives perform the same functions as FERC, they would probably have to be appointed in accordance with the Appointments Clause of the Constitution. The Appointments Clause of the Constitution requires that all federal officers either be nominated by the President and confirmed by the Senate or, if Congress by law permits, appointed by the President alone, the Judiciary or the heads of departments. U.S. Const., art. II, § 2, cl. 2. The appointments process is a practical outgrowth of the Framers' attempts to create a constitutional framework of checks and balances to act as "a self-executing safeguard against the encroachment or aggrandizement of one branch at the expense of the other." Buckley v. Valeo, 424 U.S. 1, 122 (1976) (per curiam). The Appointments Clause places an executive check upon legislative authority by not giving (continued...)

III. CONCLUSION

PUHCA reform and the creation of EWGs does not alter the interests at issue or the need to restructure the locus of the decision-making authority. The current regulatory framework as interpreted by the courts and applied by the Federal and State regulatory authorities has provided and continues to provide adequate safeguards to the American consumer and the existence of EWGs will not affect this careful balance between State and Federal interests.

21/ (...continued)
Congress the power to both create the laws and appoint those who will administer them. Thus, under the Constitution, anyone "exercising significant authority pursuant to the laws of the United States is an 'Officer of the United States' and must, therefore, be appointed in the manner prescribed by [the Appointments Clause]." Buckley, 424 U.S. at 126.

The CHAIRMAN. Thank you, Mr. Patrizia.

Dr. Cooper.

STATEMENT OF DR. MARK N. COOPER, DIRECTOR, RESEARCH, CONSUMER FEDERATION OF AMERICA

Dr. COOPER. Thank you, Mr. Chairman.

In the 1980's we learned that regulatory reform can be a risky business. We found that competition does not always fill the void left by deregulation.

We found that economic deregulation can become confused with deregulation of safety, either health or financial. We found that economic deregulation can result or be combined with complete abandonment of the antitrust laws. The result can be excessive concentration of resources, abuse of market power, and unfettered management irresponsibility that threatens the public health and safety.

On the other hand, we are convinced that the regulatory failure in the electric utility industry requires reform. The embodiment of that failure can be found in what Forbes Magazine called the "largest managerial disaster in business history, a disaster on a monumental scale." It was referring, of course, to the nuclear fiasco of the 1980's.

Recent years have reinforced the need for regulatory reform in the electric utility industry. While it is true the lights have not gone out and we have had development of some non-utility generation, we also have found increasing instance of abuses self-dealing, of denial of competitive access, concentration in the industry, and rate basing of inefficient plants.

We suffer from evermore bizarre management structures that reduce and limit management responsibility and regulatory structures that move decision making and responsibility farther from the people.

In light of past history, we must never take a narrow or short-run view of change. We must never think that economic deregulation can go forward without worrying about safety regulation. But we must also not shy away from the difficult task of implementing reform that can serve the public interest, even if it is difficult.

Fortunately the Federal legislation that created the current structure of the electric utility industry encourages a comprehensive view of that industry. The Public Utility Holding Company Act and the Federal Power Act are two titles in one law. They share one set of assumptions about the nature of the electric utility industry, were passed simultaneously, and provide complimentary functions.

We cannot abandon the central organizing principle of PUHCA, integration and coordination, without explicitly adopting another principle to guide the future of the industry.

We propose integrated resource planning, adopted as a Federal principle, just as integration and coordination were adopted as a Federal principle for organizing the industry 50 years ago.

We cannot switch from vertically integrated utilities, which internalize intermediate transactions, such as the purchase of transmissions services, to horizontally organized market transactions without making provision to regulate those market transactions when they involve bottle-neck facilities or strategic commodities. We propose open and fair competition to meet the needs identified by individual utility resource plants.

We cannot move from the historical pattern of locally managed, equity-based, risk-averse entities to market-oriented, single-purpose generation companies without making provision for managing the risks that are inherent in those market transactions.

We propose requiring explicit rules to prevent ratepayers from being exposed to additional financial risks.

We cannot create a host of new, affiliate transactions, which were the most pernicious abuse that PUHCA addressed, without creating explicit regulatory authority to prevent abuse of those transactions, and ensure that consumers actually benefit from them.

We propose to ban self-dealing between unregulated and regulated companies within one holding company, and to require explicit regulation by the States to prevent cross-subsidy and ensure a positive benefit to consumers.

We cannot create yet another mechanism for Federalizing utility regulation, when the logic of economic change in the industry runs in the opposite direction.

The predicate of competition and generation which we fully endorse is that economies of scale are now small in comparison to demand. If that is true, then local decisions about the acquisition of generation should prevail.

We propose to make the States the ultimate arbiters of the acceptability of both structural relationships and transactions within the industry—while FERC sees to the competitiveness of interstate markets.

Any change in PUHCA must be pro-competitive, and protect consumers from abuse. These conditions must be stipulated in advance, not only in the clear delineation of authorities, but also in the stipulation of minimum standards to be implemented by those authorities.

The process of finding an appropriate structure for the industry has only just begun. Neither of the pieces of legislation before this committee dealing with this issue fully addresses our concerns.

But we believe we could move quickly forward if those who believe in competition recognize the legitimacy of those concerns, grounded as they are both in the Federal legislation that was enacted 50 years ago, and the actual experience of regulatory reform in other industries that took place in the past decade.

Thus, we look forward to working with the committee and Congress to crafting effective regulatory reform legislation that enables us to capture the benefits of competition without exposing the ratepayer to undue risk of premature or ineffective deregulation.

Thank you.

[The prepared statement of Dr. Cooper follows:]

Consumer Federation of America

TESTIMONY OF
DR. MARK N. COOPER
DIRECTOR OF RESEARCH,
CONSUMER FEDERATION OF AMERICA

On

REGULATORY REFORM IN THE ELECTRIC UTILITY INDUSTRY

Before the

ENERGY AND NATURAL
RESOURCES COMMITTEE

UNITED STATES SENATE

MARCH 14, 1991

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

Mr. Chairman and Members of the Committee,

My name is Dr. Mark N. Cooper. I am Director of Research of the Consumer Federation of America (CFA). Founded in 1968, CFA is the nation's largest consumer advocacy group, composed of over 240 state and local affiliates representing consumer, senior citizen, low-income, labor, farm, public power and cooperative organizations.

We appreciate the opportunity to testify on Title XV of S. 341.

THE FAILURES OF DEREGULATION AND REGULATION

Throughout the first decade and a half of our history, CFA was a vigorous supporter of competition, deregulation and regulatory reform. We supported the deregulation of airlines and railroads. We supported the break up of the telephone company.

In the 1980s, however, as an extremist free market philosophy gripped Washington, we discovered the downsides of deregulation.

> We found that competition did not always fill the void left by deregulation, resulting in unregulated market power and growing market abuse.
>
> We found that economic deregulation was confused with deregulation of safety -- both financial and health -- resulting in unfettered management irresponsibility that threatened the public health and safety.
>
> We found that economic deregulation became confused with complete abandonment of anti-trust laws, resulting in excessive concentration of resources and abuse of market power.

As a result of this real world experience, we have become much more cautious about reform of industrial and regulatory structures. We still prefer competition and regulatory reform, but we insist that the underlying economic conditions be such that they truly will support competition and demand that the institutional structures created foster competition and provide genuine consumer protection.

Four years ago I appeared before Congress and addressed the issue of electric utility regulation.[1] I examined the intersection of the two most important factors that influence our attitude toward reform in this industry: our experience of deregulation in other industries and our experience of regulatory failure in the electric utility industry. I would not change a word.

Sound regulatory reform still must be based on a clear understanding of industry structure and a sensible analysis of what the real problem is. It must not be based on speculation or blind faith in the market. Captive consumers still bear all of the risks of deregulatory schemes that say "let the market work and see what happens" because they are the weakest actors in the market. If the market doesn't "work," it is the residential ratepayer who pays the price.

In fact, with another half decade of experience, with increasing concentration in the airline industry, with skyrocketing prices in the cable television industry, with the ever increasing cost of the S&L bailout, we are even more suspicious of simplistic "let the market work" schemes.

On the other hand, we are still convinced that the regulatory failure in the electric utility industry needs to be fixed. The embodiment of that failure can be found in what _Forbes_ magazine, the self-styled tool of capitalism, called in a February 11, 1985 cover story the nuclear fiasco of the 1980s.

> The failure of the nuclear power program ranks as the largest managerial disaster in business history, a disaster on a monumental scale. The utility industry has already invested $125 billion in nuclear power, with an additional $140 billion to come before the decade is out, and only the blind, or the biased, can now think that most of the money has been well spent. It is a defeat for the U.S. consumer and for the competitiveness of U.S. industry, for the utilities that undertook the program and for the private enterprise system that made it possible.

The intervening four years have not proven that regulatory reform is unnecessary. While it is true that the lights have not gone out and non-utility generation has continued to grow, it is also true that we have experienced significant increases in abusive self-dealing, denial of competitive access, concentration in the industry, and rate basing of inefficient plants. We suffer from ever more bizarre management structures that reduce and limit management responsibility and regulatory structures that move decisionmaking and responsibility farther from the people.

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[1] "Testimony of Dr. Mark N. Cooper on Electric Utilty Regulation," _Subcommittee on Energy and Power, Committee on Energy and Commerce, United States House of Representatives_, September 23, 1987.

Some have said that regulatory reform in the electric utility industry could create the conditions for an S&L crisis. I say we already have had one S&L crisis in the electric utility industry. What we have not had is the structural and regulatory reform to prevent another economic disaster.

Thus, my conclusion today is the same as it was four years ago. Although the two thrusts of regulatory reform emerging from the nuclear fiasco may seem contradictory, they need not be. Competition under conditions of strict equal access to bottleneck facilities should be encouraged, where it is workable. Where residual regulation is necessary, it should be rate of return regulation that injects incentives and polices costs vigorously.

Where competitive principles can be injected within the context of vigorous regulation, they should be. For example, bidding for acquisition of generating capacity is a good idea. However, it must come in the context of a resource plan that carefully judges the need for capacity, uses a reasonable time frame, does not shift all risk to ratepayers and allows all parties to compete on an equal basis.

Competition and deregulation are great in theory -- but they must not mean simply a switch from the regulation of monopoly power to the unregulated exercise of market power. If the consumer movement has become a bit more hardheaded about deregulation, it reflects our experience in other industries.

We believe that regulation which gives competitive forces a freer hand and allows incentives to play a larger role can achieve the bulk of efficiency gains in an industry which still possesses significant monopoly characteristics, without unnecessarily exposing consumers to the risks of deregulation.

THE NATURE OF FEDERAL ELECTRIC UTILITY REGULATION

In light of past history, all who advocate regulatory reform and industrial restructuring must never take a narrow or short run view of change. They must never think about economic deregulation without thinking about safety regulation. They must never think about free market activity without worrying about market concentration or anticompetitive tactics and strategies that develop in the absence of regulation.

Fortunately, the federal legislation that created the current structure of the electric utility industry encourages a comprehensive view of the industry. The Public Utility Holding Company Act and the Federal Power Act are two titles of one law. They share one set of assumptions about the nature of the electric utility industry, were passed simultaneously and provide complementary functions.

Thus, given the history of the federal regulation of electric utilities and the recent experience in federal deregulation of other industries, it is simply impossible to suggest that regulatory reform is a question of PUHCA and not the FPA.

I may argue that the fundamental nature of the industry has changed sufficiently to require modification of PUHCA. I then have the responsibility to ask whether that very same change in the basic nature of the industry also requires change in the Federal Power Act.

I may argue that the central organizing force of PUHCA which restructured the industry -- the integration and coordination requirement -- and the structure it created -- vertically integrated state-based entities -- are no longer appropriate. I then have the responsibility to ask whether the transactional structure and the allocation of regulatory responsibilities fostered by PUHCA and the FPA are appropriate.

I may argue that the detailed financial regulation of entities which fall under PUHCA (as opposed to those that were restructured beyond its control) may no longer be appropriate. I then have the responsibility to identify where entities lie on the regulatory terrain and what regulation is necessary at each point.

THE ELEMENTS OF REGULATORY REFORM

We simply cannot avoid these difficult questions when they flow directly from the reforms we propose. There are five broad areas in which I believe issues must be addressed. Appendix lists some of the general and specific policy resolutions that underlie this analysis.

INTEGRATED RESOURCE PLANNING

PUHCA was unabashed in its willingness to adopt a public interest principle for organizing the industry. It accepted the fact that market transactions would not prevail and instead embraced integration and coordination for vertically integrated companies as the principle. Efficiency through integration had to be shown and was assumed to be the goal.

The public interest standard imposed on the industry was defined by both function and outcome. Any form of organization that could meet the integration and coordination requirement and prove that it delivered the outcome was acceptable. The framers of the law knew well which organizational forms would not meet this standard (in most cases the dreaded holding companies) but they did not delineate a list of those that would. Instead, they established a standard.

If this standard is to be abandoned, another must be put in its place. Without an organizing principle, the industry could evolve in unacceptable ways. We are no longer willing to say simply let the market decide, especially where natural monopoly persists at the point-of-sale.

The organizing principles that clearly have been emerging and which any reform must reinforce are integrated least cost resource planning and competitive bidding to fulfill those plans. As a general principle, the form of organization should be secondary to the function and outcome.

We have clearly adopted similar principles for other industries that provide basic services indispensable for daily life in the modern world. In telecommunications we speak of affordable universal service as an outcome and support dedicated telephone companies as the vehicle. In banking we seek affordable basic banking as an outcome, with community-oriented activities as the criteria for access to taxpayer support.

COMPETITIVE ACCESS TO THE MARKET

Vertically integrated utilities do not transact for intermediate services, like transmission. Horizontally de-integrated entities, which would be the result of the reforms before the Committee, must do so. The regulatory structure of the industry is not adequate to ensure a proper functional basis for an industry demanding a new transactional basis. The legal authority and institutional inclination of FERC to provide for competitive access does not exist.

We have precisely the same problem in all of the network industries -- joint rates in railroads and fortress hubs in airlines are good examples. Deregulation without assurances of competitive access leads to a shut-down of bottlenecks and anticompetitive pricing and abuse.

Over the years and across all industries we have insisted upon reasonable rules for competitive access to essential facilities and strategic commodities. These include, for example, equal access in telecommunications, competitive access in railroads, and non-discriminatory access to programing in cable television.

Of course, allowing access to transmission is only a small part of creating true competitive access. All procurement, be it supply or demand side, must be let out to bid on conditions that are fair to potential competitors. These include technical specifications, financial requirements, and risk allocation.

RISK MANAGEMENT

Since the 1930s, we have had almost no bankruptcies in the electric utility industry. It is a remarkable record that stems in part from the fact that the federal legislation forced utilities into locally managed, equity-based, risk averse entities. Assets could not be drained away from one area to another and the relationship between the asset base and the locally available market was preserved by state regulation which was founded on the granting of a franchise. If a holding company existed, with its threat of the transfer of assets from one subsidiary to another, it was regulated as to the detail of its capital structure and the nature of its internal transactions.

We are now faced with the prospect of a string of single asset subsidiary companies spread across the nation under a parent holding company which is not subject to the financial strictures of PUHCA. State regulators will not have the power of the franchise over these entities, they will only have the much weaker power of contracts.

Only once in the history of the industry did the balanced, risk averse approach fail. We got away from it when single asset nuclear facilities came to represent huge commitments of resources out of all proportion to the asset base of companies.

Other examples of the devastating impact of the shift of risk pervade the S&L and airline industries. Asset poor corporations cannot be allowed to impose a burden on the public either directly, as in the case of captive ratepayers or taxpayers, or indirectly, as in the case of those who hold unused tickets on bankrupt airlines.

While we recognize the benefits of diversifying risk through multiple sources of supply, and that non-utility generators bear more of the front end risk of construction, we still worry about the back end risk of operation that ratepayers bear. If single asset subsidiaries fail, ratepayers must bear the burden of replacement power because demand for electricity is inelastic. Financial responsibility for the life of the project must be ensured in some fashion and contracting alone is not enough.

Over the years and across all industries we have insisted upon reasonable mechanisms to manage the risk imposed on the public. These include, for example, prescription of capitalization ratios in S&Ls and ticket insurance in the airline industry.

AFFILIATE TRANSACTIONS

Abuse of affiliate transactions was among the most pernicious of abuses that PUHCA addressed. PUHCA was hostile to transactions between utility operating companies and unregulated affiliates in the extreme. Although some would argue that by preventing dealings between interstate affiliates of holding companies, it fostered "self-dealing" though intrastate or exempt holding companies, the law did not eschew scrutiny of such dealings, although Securities and Exchange Commissions have not been vigorous in this endeavor. Nor was "self-dealing" under the Public Utilities Regulatory Policy Act a desirable outcome.

Abuse of affiliate transactions remains a major problem spanning telecommunications, banking, and even the airline industry, where various transactions have stripped operating companies of their assets to the extent that major airlines have negative equity.

Relaxing barriers to the creation of affiliates requires a clear policy on what should and should not happen. Self-dealing is simply unacceptable. Competitive affiliates require extensive oversight and demand great scrutiny. Not only must consumers be protected from abuse by these affiliates, they must reap tangible benefits from this activity if it is allowed.

STATE-BASED REGULATION

PUHCA definitely favored a state-oriented industry because states could not regulate the far flung activities of holding companies. Not only was state utility regulation only emerging in the 1930s, but communications were weak and resources lacking for state regulators to chase down affiliate transactions.

In recent years there has been a drift toward federal regulation. Relaxing the integration and coordination requirements of PUHCA could certainly stimulate further federalization of activity, yet this is counter to the direction of underlying economic change. The predicate of competition in generation is that economies of scale are now small in comparison to demand. If that is true, local decisions about the acquisition of generation should prevail.

Economic efficiency in the management of the transmission system does not require concentration of ownership or the federalization of regulation. Neither concentration nor federalization should be the outcome of regulatory reform. Therefore, regulatory reform must be accompanied by explicit transfer of authority back to the states and local regulatory authorities where possible.

One obvious step is to ensure that the ultimate authority for prudence lies with those who set retail rates. Prudence reviews are not the only, nor are they the best vehicle to protect consumers. After-the-fact reviews rarely achieve full restitution, fail to compensate for lost opportunities, and cannot repair the damage to competition.

Powers to determine the structural relationships between ratepayers and suppliers must also rest with the states. Contracts alone are not an adequate basis for establishing these relationships, since ratepayers, through their agents (utilities), enter commercial relationships under a disadvantage -- the obligation to serve.

ACHIEVING REGULATORY AND INDUSTRIAL REFORM

The above five areas define our central concerns about how regulatory reform and industry restructuring should proceed. Any change in PUHCA must be pro-competitive and protect consumers from abuse. That outcome can be achieved only if the following conditions prevail at the time that new activity commences.

> The future need for electricity must be met through integrated resource planning that considers both supply and demand side options.
>
> Those options must be supplied subject to competition which is fair and open.
>
> The financial nature of the entities engaging in the competition must be reasonably regulated to avoid shifting risks to ratepayers.
>
> Affiliates must be prevented from distorting the marketplace through self-dealing or cross-subsidization.
>
> The regulatory bodies that actually lay the burden on ratepayers must have extensive and

ultimate authority over the process.

These conditions must be stipulated in advance not only in the clear delineation and delegation of authorities, but also with minimum federal standards for implementation of those authorities. We are simply not going to accept any more assertions of blind faith in the marketplace or unspecified assurances that some other regulators will take care of the problem. Federal anti-trust regulation in the airline industry and economic regulators in the cable and railroad industries have failed to promote competition; federal financial regulators in the S&L industry failed to prevent irresponsible management from shifting massive risks to taxpayers; federal and state regulators are laboring and failing to prevent abuse of affiliate transactions in telecommunications and in the area of PURPA-regulated utility transactions.

If the federal government recedes from regulating specific types of activities, it has an obligation to tell the states at a minimum what they must do, although states can certainly decide if they wish to do more.

Since I testified before this committee on this subject four years ago the debate has matured considerably. I am optimistic that we will be able to capture the potential benefits of competition in the electric utility industry while avoiding the pitfalls of previous premature, excessive, or irresponsible deregulations.

We must recognize that the process of finding an appropriate structure for the industry has only just begun. Neither of the bills before this committee addresses our key concerns, but I believe that the process could move quickly forward if those who believe in competition recognize the legitimacy of these concerns, founded as they are in the history and intent of federal electric utility law and the actual experience of reform in other industries.

APPENDIX I

CFA POLICY RESOLUTIONS ON REGULATORY REFORM IN THE ELECTRIC UTILITY INDUSTRY

CFA deplores the rhetoric currently employed by many corporate lobbyists that makes all regulation and all regulatory agencies scapegoats for so-called excessive costs. CFA believes legislators should carefully distinguish between those regulations that promote public health and safety, equal opportunity, a fair marketplace, or a healthy environment and those that mainly protect favored industries from legitimate competition. The former should be vigorously enforced and the latter, which truly are inflationary, should be abolished or reduced. (p. 77)

The Public Utility Holding Company Act of 1935 (PUHCA) should not be weakened or abolished. Amendments to PUHCA designed to increase competition in the bulk power market must also provide for transmission access, promote the interests consumers, and ensure effective regulation. (p. 53).

Choices about how to meet the nation's need for electricity in the decades ahead are among the most important economic decisions facing American consumers Reasonable prices coupled with assured supply are significant consumer goals. In dealing with future requirements, the most effective approach is to assess a full range of alternative approaches, including local fuel resources, conservation, load management, cogeneration, plant-life extension, imported hydroelectric power, domestic surplus generation, expanded transmission and new power plant construction to determine the "least cost" answer to secure an adequate and reliable supply of electricity. (p. 50)

FERC should require interconnection and wheeling of electricity between utilities whenever such action will benefit consumers and ensure market competition. (p. 51)

Congress should enact legislation to strengthen inter-regional power pooling and bring about a nationwide power grid. The Department of Energy (DOE) national power grid study recommended that non-discriminatory access to excess transmission capacity should be assured by federal and state regulatory agencies where such access is technically feasible. To this end, Congress should enact legislation to encourage coordination and integration in the electric utility industry to ensure that all elements of that all consumers have access to electricity at a reasonable price. Two elements of that legislation must be strengthened: antitrust review and expanded authority for the federal government to order wheeling. (p. 51)

For facilities under construction, consumers should bear an equitable share of prudently incurred costs when plants come on line. (p. 50)

State regulatory commissions should encourage maximum utilization of excess capacity. (p. 51)

PURPA should be implemented in a manner that is consistent with least cost planning and that minimizes the cost to consumers. (p. 53)

The public interest test for electric and gas utility diversification should be that ratepayers receive ongoing tangible economic benefits from such diversification, and that no revenues recovered for the provision of basic or regulated activities or affiliates. (p. 53)

The CHAIRMAN. Thank you very much, Dr. Cooper.

On this question of Pike County and registered holding companies, and so-called Pike County fix, Ms. Eckert, you all exercise that power, the so-called Pike County power, right now, do you not?

Ms. ECKERT. Yes, we do, Mr. Chairman.

The CHAIRMAN. And do you feel confident that that is the law?

Ms. ECKERT. I feel very confident. And there are California laws and considerable legislation, buttressed by many consumer groups that give us the power that we need to avoid any abuses or potential abuses in that area.

The CHAIRMAN. Now, we have been strongly urged to put in—urged by people for whom I have enormous respect, affect, and depths of gratitude for all the good work they have done for the city, State—for a great statesman as well—and that is the New Orleans City Council to put in a Pike County fix.

Mr. Giarrusso, you have seen our Pike County fix, that subsection G? Mr. Vince, if you wanted to answer that technically?

Mr. VINCE. Yes, we think that is a very good step in the right direction, to codify Pike County. And we have——

The CHAIRMAN. And you think that, for the limited purpose of codifying Pike County, that achieves the purpose?

Mr. VINCE. Yes, we do want to clarify, of course, that outside the Pike County area we have some concerns about the holding company context as a result of the Mississippi Power and Light decision. But that is a separate issue.

We think that your attempt to codify Pike County is very good.

The CHAIRMAN. Now, Mr. Patrizia, you oppose the codifying of Pike County. Do you think that there is still substantial legal doubt as to that?

Mr. PATRIZIA. Well, as Commissioner Eckert said in her own testimony, Mr. Chairman, the Supreme Court of the United States has not ruled on Pike County. That issue is still, in that sense, open. Pike County itself was only the determination of an intermediate appellate court in the State of Pennsylvania.

Certainly I would agree with both Chairman Eckert and Mr. Giarrusso, that there are a number of authorities in a number of States that revolve around the question of reviewing prudence or reviewing other activities of jurisdictional entities in those States.

Codifying Pike County as such may or may not address all of those issues. Each of those States has passed its own laws. They have their own ways of addressing those issues. And I am not sure that federally codifying Pike County in that sense is necessary, to do anything in regard to State authorities.

I would add, Mr. Chairman, that the concern, of course, of the registered companies is that if there is to be anything which addresses the issue of codification of Pike County, it has to take into account the context of the industry—for the multistate holding companies, we cannot be left in a situation where we are subject to second-guessing by three, or four, or five different commissions coming from three, or four, or five——

The CHAIRMAN. I understand. Let me get on to the next question.

The fix on Pike County is fairly easy, straightforward. Where you get into problems is when you try to take the next step, which is to deal with multistate holding companies and planning, joint state planning. That is enormously difficult. You have seen, I think, the draft of our first effort here. And it is, you know, some would say it does not do anything much. It just sort of takes a few steps. Others would say it goes way too far.

Frankly, I am beginning to think that the way we ought to solve this is to—in addition to the Pike County fix—to say with respect to multistate holding companies and purchases from EWG's, that the State PUC have a veto with respect to those purchases—not otherwise deal with the power of registered holding companies to deal with all their powers, you know, with planning, generation, et cetera—but simply with respect to purchases from EWG's.

In other words, it would be a complete fix in so far as the additional powers conferred by this bill is concerned.

Mr. Giarrusso, did I not get from your testimony that that would allay your concerns?

Mr. GIARRUSSO. Mr. Chairman, we think that would be an important step forward.

The concern we have also—two other points. One is the affiliates that a holding company now can develop just by changing corporate form, entering into interstate sales. How do we protect the consumers in that situation?

And in addition, how do we——

The CHAIRMAN. Well, what I am saying is you would have a veto on purchases from an EWG.

Mr. GIARRUSSO. Yes, and that is extremely positive.

What we remain concerned about is what happens when a holding company establishes its own, independent affiliate and has interstate sales with that affiliate?

The CHAIRMAN. To somebody else, you mean?

Mr. GIARRUSSO. Yes.

The CHAIRMAN. Well, I do not understand how that deals with the Pike County, Middle South problem.

Mr. GIARRUSSO. What would happen, is we have the veto on EWG's would solve one portion of the Mississippi Power and Light problem, but not our entire problem with Mississippi Power and Light.

What has happened, basically, in the holding company situation, is previously, States have had complete jurisdiction over generation sales. Now with the interpretation of Mississippi Power and Light, that has been taken away from States.

To the extent that States would have veto power over EWG's, that is an important advancement, and one that we want to complement and support.

The CHAIRMAN. Well, the problem you are talking about is—is this a problem which would be generated by this legislation?

Mr. GIARRUSSO. It is a problem inherent whenever holding companies can take any measures to increase their wholesale-level sales.

The CHAIRMAN. Well, they can do that now, under present law. Can they not?

Mr. GIARRUSSO. That is a deep concern that we have.

The CHAIRMAN. Well, you want us to fix present law, in addition to providing protections under this act?

Mr. GIARRUSSO. Yes. And what we want to do is not say because you are doing—the holding companies are asking for brain surgery on one aspect of their problem, that you ignore the vital signs of the rest of the patient's body.

The CHAIRMAN. Well, I think if we do a Pike County fix and gave you a veto over purchases, now, you know, you cannot expect us to reform the whole United States Code. You know, this is—if we could do that, I think you should be satisfied and take yes for an answer, and not say, well you have to fix other problems that are not generated by your bill, but might be nice to have.

Mr. GIARRUSSO. Mr. Chairman, this is not an abstract problem for New Orleans and the rest of your State, and Arkansas, and all of the——

The CHAIRMAN. Well, I know it is not, but it is not one generated by this act, either. I mean we have a lot of problems in our State that we are not fixing in this act.

Mr. GIARRUSSO. With great respect, Mr. Chairman, what we would simply say is if you are going to look at an aspect of improving competition in the industry, and you are going to try to protect consumers in the process, the omission that we are describing is a rather important one. And what we would end up with is still a situation where a holding company could avoid our regulations simply by changing its corporate chart.

And so we are asking for—as you look at this issue, to look at it completely, rather than fixing one part of it, but giving holding companies an opportunity to simply do an end-run around the State commissions.

Thank you, sir.

The CHAIRMAN. Mr. Patrizia, suppose we had that veto of the state commissions on the purchase from an EWG. Now this would not be a veto for their participation in selling to others, or, in no way affect the internal management of holding companies.

Suppose we had that? How much, how difficult?

Mr. PATRIZIA. I do not think that would work, Mr. Chairman, for at least the following reasons. And I may well be even more thoughtful tonight, and send staff even more reasons. But let me go through a few that come to mind immediately.

The CHAIRMAN. By the way, we would solicit on all of these questions, all these issues, any further written statements from all of you. And anyone in the audience who wants to give us a letter, we would be glad to hear that too.

[Laughter.]

Mr. PATRIZIA. In a situation where a particular State would have a veto authority over the purchase from an EWG, the effect would be that a registered utility holding company, in which all the capacity is centrally dispatched, and all of the capacity is serves to serve all of the load of the integrated system.

An individual State could veto something that would be for the benefit of all of the other States in the system. Now that would be a great upsetting of the way an integrated system ordinarily has to function. It would make it virtually impossible for a registered company to purchase from an EWG.

The CHAIRMAN. Well, they cannot do that now.

Mr. PATRIZIA. Oh, on the contrary, Mr. Chairman—right now, any purchase that we make in the system, assuming that it flows through as part of the system agreement, is approved by the Federal Energy Regulatory Commission. That is why I said in my testimony that we continue to believe that the Federal forum is the proper forum to make these determinations.

The CHAIRMAN. Well, I mean, an EWG is a creature created under this act.

Mr. PATRIZIA. Absolutely correct, Mr. Chairman.

The CHAIRMAN. So you cannot purchase from them, because they cannot be created, because the Act is not passed.

Mr. PATRIZIA. But let me raise the Ocean States matter that came up this morning.

Ocean States is an independent power project. It is the functional equivalent of an EWG in the sense that it is outside of the ordinary utility structure. And it was created in this instance only by what I think Ms. Stuntz or Ms. Marlette mentioned this morning as being a jury-rigging of the structure, a very complicated corporate structure that was created in order to permit it to exist outside of the Holding Company Act strictures.

Energy and capacity from Ocean States flows to a registered holding company. And the rate at which that capacity and energy is purchased is controlled by the Federal Energy Regulatory Commission, and then passed through.

If we had to go through separate vetoes by each of the States to which that capacity and energy might ultimately be delivered, it would have been impossible to do that sort of transaction, so we would lose the efficiencies in the system.

The CHAIRMAN. But that is not a—that is not an EWG, as defined.

Mr. PATRIZIA. It is not an EWG, that is correct.

The CHAIRMAN. What I am saying is limit the veto to purchases from an EWG created under this act. So that in terms of purchases, a registered holding company would not be prohibited from doing anything that they can do now. What it would say is, if Middle South, for example, or whoever, wanted to purchase from an EWG and allocate, that you would have to have an agreement among the PUC's in the allocation of that power.

And if they could not all agree, then they could not purchase from the EWG. They would have to purchase from or generate themselves, or purchase from the sources that they can get now. Why would that not be a good fix for this?

Mr. PATRIZIA. Because the problem, Senator, is that it would mean that registered companies would not have the ability to deal with EWG's on the same basis that others do. In effect, the State of Louisiana might well end up in the situation where the State of Arkansas or the State of Mississippi decided that they did not want a purchase from a particular EWG to occur—whether because that EWG happened to be located in Louisiana, or because they did not like the way the allocation went, or they did not like something else about it.

So the benefits that would otherwise have accrued to the system as a whole, benefits that might accrue to the State of Louisiana would not——

The **Chairman**. Well, they might not see that as a benefit. You see, you have Mr. Giarrusso who is testifying about Grand Gulf. He does not think that is a benefit for Louisiana.

I can tell you, Dale Bumpers did not think Grand Gulf was a benefit for Arkansas.

Mr. **Patrizia**. I am very conscious of that, Mr. Chairman, and I appreciate those concerns. My answer to that is the reason that somebody has to make those decisions, is that somebody has to make those decisions.

And if you leave them to—some effort to reach unanimity at some point down the road, speaking as a lawyer who has been in practice for about 15 or 16 years, and a good chunk of that doing energy work, trying to reach agreements with three or four different States, Mr. Chairman, is like herding cats.

It just does not work.

[Laughter.]

The **Chairman**. I quite agree with you, Mr. Patrizia, and to try to come up with legislation to provide for mandatory joint planning is just—I mean, it really hurts the brain, and at the end of your endeavors you find out you did not do it. It is like trying to write a manual for how to herd cats.

[Laughter.]

Mr. **Patrizia**. I appreciate the effort, Mr. Chairman. I am not suggesting it is an easy task. What I am suggesting is that we have an existing regulatory structure through the Federal Energy Regulatory Commission.

The **Chairman**. We would not be dealing with that.

Mr. **Patrizia**. I understand, Mr. Chairman. What I am saying is what we ought to do is have a situation where the States can take the positions that each individual State reaches based upon what that State believes is in its interest, and have some neutral arbiter make the decision on those matters, which is what FERC does now.

I have to say, Mr. Chairman, that there are a lot of cases that come through FERC that are settled because everybody can reach a determination of what is an appropriate allocation or recognize the benefits that are being shared.

The **Chairman**. Let me cut you off there, because I do not have much time. If we can get this for you, Mr. Giarrusso—I mean, as you can tell, this is not the kind of thing that is universally embraced, certainly not by the registered holding companies.

If we can get you a veto, which frankly I did not start out the morning there, but I am persuaded that that would be the cleanest, easiest way to do it, a veto on purchases from an EWG, that would give the Louisiana PUC, for example, authority to come in and say no, if they wanted to purchase power from Grand Gulf. Let us say Grand Gulf was an EWG. You could say no, and then we would do the Pike County fix.

What we would not do is try to go in and rewrite all of this law on registered holding companies, because in the first place I would not know how to write it, and in the second place I think it is asking way too much, and you know, everybody wants to fix all of the problems they have got in a piece of legislation. We could throw wetlands in here, too, you know. That is a big problem.

But I am thinking in that direction, and I would submit to you, Mr. Patrizia, that if we did have that kind of a fix it really would not take anything from you that you do not have right now.

Mr. PATRIZIA. Mr. Chairman, I would say that it would not take from us something that we do not have right now, but it also would not achieve the benefits that you are trying to achieve, as I understand it, in the bill.

There are efficiencies to be realized here, and if there are gains to be accrued——

The CHAIRMAN. I tell you what it would do. It would give the benefits to everybody else and it would allay the fears of people who have been burnt once on this Middle South thing. I mean, they got burned in a very direct way, and they do not want that to happen again because of EWG's, and I think we ought to try to fix it for them.

Well, I have already gone on too long.

Senator Wallop.

Senator WALLOP. Mr. Chairman, thank you.

Let me state to the panel and those which preceded it and to the committee that I apologize for not having been here. Having sat on an airplane that ran off the runway in Pittsburgh last night, I did not get here until 3:00, and then when I got here found that one of my other favorite subjects, SDI, was on the floor, and so I have been kind of out of the picture for the morning.

But I think Chairman Johnston's line of questioning has been fascinating and illuminating. There is much to be learned about this issue.

I have a sense, as I have not only talked to people in private but in view of the statements that have been made that the whole process, Mr. Patrizia, of reforming PUHCA is much like herding cats, it seems to me that as soon as you get to the point of satisfying the anxieties of the registered holding companies you create new anxieties for the IPP's, and if you got either of them close to a level of comprehension and understanding, then the State PUC's come in.

I am persuaded that what Senator Johnston and I are trying to do is a thing that is worth doing. I am not persuaded that it is ripe. I do not know if this is a fruit that will ever ripen, but I am persuaded that at sometime or another it needs to be done.

What I would say is that I am hopeful that we do not somehow or another, in our anxiety in trying to do something that we believe to be right in this area, derail what would be very important and comprehensive legislation.

But let me just ask one question. The afternoon is long, and others have been here and more attentive than I, but Dr. Cooper, your written testimony—and I was not here for all of your oral testimony, but it draws a parallel between the deregulation of other industries and the deregulation of the electric utility industry, and my question to you: is that parallel really there?

I mean, in fact, is not the crux of PUHCA reform as proposed in both S. 341 and S. 570 a shifting of regulation from the States to the Federal Government, and not the deregulation of electric power plants?

Dr. COOPER. Well, it is not in the following sense: we are proposing to remove a very heavy regulatory burden in the Public Utility Holding Company Act which has dissuaded people from entering into certain types of arrangements.

There are only nine registered holding companies. People do not like to be registered holding companies. We are about to make it legal to do something that would have forced them to be registered holding companies if they did it, okay, so that we have basically said you can now engage in certain kinds of activity that would have subjected you to the Public Utility Holding Company Act. It will not.

So in that sense we are deregulating those activities with respect to what existed in the Public Utility Holding Company Act.

Senator WALLOP. But we are not relieving them of regulation?

Dr. COOPER. What we are doing is, we are saying, as the legislation does, we think somebody else can regulate that. These States are there, and FERC might do it and the SEC might do it, and that is exactly what we worry about, is whether the other regulators who we think can do it (a) actually have the power. California has the power. Some States do not have the power; (b) Do they exercise that power? Some States have those authorities but never exercise them; and (c) Even if they do have the authority, do they have the resources to do it?

That is very much what happened in some of these other industries. When we deregulated airlines, we said there will be antitrust laws, and then we never stopped the merger, and we are getting down to very few airlines.

When we deregulated railroads—and I use those examples because we supported deregulation in that industry. When we deregulated railroads, we said, there will be residual regulation at the ICC, and then when we looked at the rules they promulgated, they established a limit price, and consumers did not like that.

So we have learned a lesson about deregulation. I agree with you, both bills assert with varying degrees of authority, there is a regulatory authority some place else. What we are saying is (a) we have to make sure it is there; (b) we have to make sure we know it is going to do exactly what we want it to do, not in great detail but outlining it in the bill.

So in a certain sense you are right, the assertion is there. What we would like to see is the specifics of, here is the regulatory regime that will cover this particular activity, recognizing that we have removed the one at the Federal level.

Senator WALLOP. I guess I would have to state that I approach things from obviously a different philosophical perspective, but the only element of that which causes me to pay attention and concern is that some States do not have the resources, but a State that has the resources and chooses not to, in a democratic society is entitled to that, are they not? I mean, at some moment in time, if California has opted not only to have the power but to exercise it, that is within the realm of their democratic and sovereign power as a republic of the republics.

It seems to me that other States satisfied with the arrangements that their consumers ought not to bear either the cost of Government cost if they are satisfied, or the additional cost of the regulation if they are satisfied that their consumers are being taken care of.

Dr. **Cooper**. I will split that difference with you in the following way.

Senator **Wallop**. We are not trying to skin this cat now. [Laughter.]

Dr. **Cooper**. I frankly think we ought to be in the business of what we can do, because I do want to move forward. I would say that a State which asserts that it is achieving the purposes stated of the Federal law, which is to promote competition and protect consumers, by doing something is acceptable, because then at least there is a standard, and then we can hold it up to that standard and you and I may disagree with it. We may be able to bring it into court. We may be able to bring it here for hearings. We may be able to argue it at a different agency. But it seems to me the purposes and the outcomes need to be stated so that there is the standard by which we can measure State contract.

Remember, this is a Federal law. The Federal Government will recede from regulating a certain type of activity, and I think it is legitimate for the Federal Government to state, here is the outcome, and at least in a general way, here are the standards by which we are going to measure our ability to reach that outcome.

Senator **Wallop**. I would stop short of that personally and philosophically for the reason that one of the great things about this country is the ingenuity. I mean, not all the wisdom resides inside of this building.

California has demonstrated that they can do things, even in spite of a Federal holding company act, that is in the interest and the belief of their consumers. Other States have approached their obligations in different ways, each with the idea in mind that they are serving their consumers, or serving their fundamental governmental role, and I have a hard time for the Federal Government always substituting its judgment as to what is and is not acceptable in the eyes of their consumers.

Mr. Vince.

Mr. **Vince**. Senator, just to supplement that point, have you ever seen or heard of three or four cats trying to guide an 800-pound holding company gorilla? It is a very difficult task, especially in the context of Mississippi Power & Light.

State's traditional role of governing generation addition decisions has been stripped on holding company systems, and we need to make sure that an act which would really encourage further wholesale level transactions at the expense of States have some counterbalance to the States.

We have heard criticism today of the concept of a regional group of States getting together and regulating a holding company, but the only criticism that I have heard is that it might take too long. Frankly, the proposal we have would be much shorter. It would be a 6-month period, which is much shorter than most Federal decisions. We have had 2- and 3-year decisions at the Federal level.

Secondly, the criticism of uncertainty, but the proposal we have would require all of the States, once they have voluntarily formed a regional board, to adhere to whatever decision is rendered by that board, so instead of the dual track litigation we now have, where holding companies are proceeding in both State and Federal contexts and lots of lawsuits, instead of that you would have one single body dealing with these issues, and if they were not able to complete their decision within the 6-month period of time it would revert to the FERC.

Senator WALLOP. That is precisely the kind of thing that tells me that amongst the States there is maybe more flexibility and more interest in competition than there is around the confines of the beltway, where legitimate interest groups nonetheless have a more centralized view of what constitutes acceptability in and around the country, and thus the country itself.

I thank you for that. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wallop.

Senator Wellstone.

STATEMENT OF HON. PAUL WELLSTONE, U.S. SENATOR FROM MINNESOTA

Senator WELLSTONE. Thank you, Mr. Chairman. I, too, apologize for not being here this morning. I had several conflicts. I have a couple of concerns, and the question that I want to address especially to Ms. Eckert and Dr. Cooper speaks to these concerns. I would invite the other panelists to respond as well.

In 1989, the National Association of Regulatory Utility Commissioners strongly opposed amending the Public Utility Holding Company Act of 1935 unless four specific provisions were included. One of those provisions had to do with the right of each State utility commission to conduct bidding programs and least-cost planning programs and to determine the appropriate mix of generation in terms of fuel and technology choice and in terms of ownership.

As the chairman knows, I am very interested in how we can manage a transition to a sustainable energy future, and I believe efficient energy use and developing renewable resources indigenous to the different regions is going to be crucial to that future.

I have two questions.

One, I want to ask first Ms. Eckert and Dr. Cooper and then other panelists as well whether the legislation, at least as now constituted, is likely to bring about a tilt toward large conventional generating facilities?

Two, since I think that utility commissions are absolutely key to being able to carry out a focus on efficient energy use, aggressive programs for efficient energy use and renewable resources, I want to know whether or not the proposed legislation as now constituted is likely to significantly reduce the power of State utility commissions to do so.

Ms. ECKERT. I will attempt to respond to that. In connection with your question about the tilt to large conventional utilities, our experience in California has been primarily with QF's—qualified utilities.

In fact, we do not have any independent power producers in California, and the growth of QF's in California has really been quite astounding, and it has been clean energy. It has been energy that has been responsive to our environmental needs.

Right now, we have approximately 5,500 megawatts, which constitutes about 9.5 percent of California's total dependable capacity, and Nation-wide roughly 4 percent has been the experience with QF's.

Now, as far as we are concerned within our State, putting into place these bidding procedures would put not only the QF's but the IPP's and the utilities on a level playing field, and they bid for different aspects. They can bid for conservation, actually. We are coming up with ways to bid for demand-side management conservation, those kinds of things.

So if anything, our experience has been very positive, because the more competition, the better the rates are for the consumers and actually the less of a tilt there is towards the large conventional utility. So that has been our experience.

Dr. Cooper. I would suggest that insofar as the legislation as now drafted creates the possibility of federalizing decisions—that is, shifting them into the wholesale marketplace—they will avoid to some extent least-cost plans, and that could potentially damage the direction of California, and that is why we stipulate integrated resource planning as a condition for the exception.

On the other hand, I am not convinced that they would necessarily tend toward the large scale. I am not one who sees independent power production as a way to raise large sums of capital. They tend to be thinly financed, and that is why I express my concerns about financial risks when we remove the Public Utility Holding Company Act.

So that at those two levels I think there are conflicting messages with respect to what you suggest. What I think they will do is lead us down the path of the traditional. That is, if you make it easier to run thinly financed companies, people are going to keep doing what they have been doing because that is what you can finance, so that there is a conflicting message there. I do not see big, but I also see the possibility for avoiding integrated resource planning, or least-cost planning.

Mr. Patrizia. Senator, I would like to preface my direct response to your questions by noting that there has been a tendency on the part of some people on the panel to talk about decisions suddenly being federalized, or responsibility being shifted from the States, and the answer to that is that that is not true.

The jurisdictional delineation of the bright line test that was laid down by the Federal Power Act was laid down in 1935. It has not been changed. The Mississippi decision did not change that bright line test. Neither did Nantahala. Neither did Narragansett. That decision was made by Congress in 1935.

It has been a very effective delineation of authority, and the Supreme Court has recognized that delineation of authority and has said that the intent of Congress was precisely to make that kind of bright line demarkation between retail rates that would be regulated by the States and wholesale rates that would be regulated by FERC.

Indeed, the reason for the passage of the Federal Power Act was the Attleboro decision in which the Supreme Court held that the States did not have the authority to regulate wholesale transactions in interstate commerce.

So I think the notion that we are shifting authority, or that decisions are being federalized, simply is not the case. Those decisions were taken 55 years ago in 1935, and that is a process that has worked very well.

Turning to your two earlier questions, Senator, on whether resource planning and things like that will be changed, or whether utilities will be left out of this, I do not think there is anything about the creation of EWG's that would cause that to occur.

I think that as you move toward a system which permits utilities to look at different kinds of mechanisms, whether it is EWG's or QF's or their own facilities, or, as Chairman Eckert has mentioned, demand side management programs, those will all continue to be in place.

I think utilities are learning, and will continue to learn, about different programs that work well. Many of the registered companies have those kinds of programs in place and will continue to do so. There is nothing about EWG's that will change that.

I do not think there is anything about EWG's that will necessarily lead to larger facilities if what you mean is a larger base load facility. I think what we could see is a situation in which we have more efficient use of some facilities, and I would think that you would support that, Senator.

For example—and let me just give one easy example. A good chunk of the generation that is going to have to be built in the next, say, 10 years is actually peaking capacity rather than base load or intermediate capacity. It is very difficult for QF's and IPP's to build peaking capacity, because you do not have a sufficient number of hours over which that facility is run for it to be easily financed, therefore they tend to end up being utility facilities.

If you could have an arrangement under which you could try to share that capacity among several different facilities and work the load arrangements properly, you might well get more efficient use out of a single facility and therefore have less capacity being built over all if you do it efficiently.

There area number of ways to look at those kinds of issues.

Senator WELLSTONE. Mr. Chairman, do I have just a minute more?

The CHAIRMAN. Sure.

Senator WELLSTONE. Because, unlike you, I am a student of this now, trying to learn every day.

Ms. ECKERT. Senator, may 1 just comment with respect to building peaking capacity? A couple of quick points I would like to make. First of all, the technology that has come about in electricity generation in the last 10 or 20 years, at least in California, has come from QF's, and I do not think we have had a chance to stress this, that the best technology that we can build will come about when we encourage more EWG's and QF's to build solar plants and to create cleaner kinds of energy.

Contrary to what you said, if we allow the EWG's to build their independent plants, they are in a much better position with respect to dispatchable power than the QF's are. The QF's are really much more tied to their steam holes and so on, and as a result they do not have as much dispatchable power with respect to meeting the peak capacities.

We feel that if the PUHCA reform is put into place and we get more IPP's that we will be in a much better position with respect to dispatchable power to meet the electricity needs when they are needed, and so I think there is another side to that.

Senator WELLSTONE. I am very interested in the question of what kinds of EWG's are likely to thrive under this legislation, and I am also interested in the question of whether or not this does indeed federalize the energy decision making or not. I am interested in preserving a decentralized State-level thrust.

Mr. VINCE. Senator, three quick points. First, with reference to federalizing it is a little bit cynical to describe regulation over generation on the basis of the 1935 act as a bright line. There is no question that States traditionally have had regulation over generation decisions. That is historically documented.

There is no question that, as a result of the Mississippi decision and holding company movement toward increased wholesale power sales, a wholesale power company now can avoid State regulation simply by forming a subsidiary that sells power in interstate commerce, and yanks the generating decision out of rate base and traditional retail level jurisdiction up to the Federal level.

It is just too cynical to say that because the bright line has been there, there has been no change in what is actually happening. Grand Gulf historically would have been a State-level generating decision.

What happened is the energy holding company formed a wholly-owned subsidiary, gave it complete ownership of Grand Gulf, made nonarm's length transactions in interstate commerce to all of its other holding companies, and State regulation went out the window.

That is not a philosophical concern or an abstract concern. That is reality in Arkansas, Louisiana, and New Orleans, and NARUC has addressed that issue considerably.

Second—I know I will be much quicker in my response here—I agree in general with Mr. Cooper's earlier comments. The problem right now is, if you open up EWG's and make them nonexempt and give increased wholesale level transactions, least-cost planning is going to become most-cost planning and the States, especially in a holding company system, just are not going to have jurisdiction over those critical issues.

The same thing with the Clean Air Act. How are you going to regulate emission allowances and credits, et cetera, on a multistate holding company system? What is going to happen is, without some form of regional body looking at that and cooperation among the States, the holding companies are going to march into the FERC and give us a cram-down under the Mississippi Power & Light case.

The CHAIRMAN. If the Senator would yield, if I could mention what I was suggesting earlier and put it in the context of what these witnesses have said, it is true, as Mr. Vince says, that under the Mississippi holding company case—the Grand Gulf case—that they did plow some new ground on laws and say, in effect, that the registered holding company, the holding company that has multistate subsidiaries, could allocate power from the Grand Gulf to States in accordance with the way Middle South planned it rather than the way the public utility commissions of the various States wanted to do.

Now, what I am suggesting in this law, or in this act—and it is not in the draft right now, but what I am suggesting is that, to the extent we create new entities called EWG's to sell power to multistate holding companies, or indeed to anybody, but to the extent that they can sell to the multistate holding companies we give to each PUC covered—in the case of Middle South, Mississippi, Arkansas, Louisiana—give them a veto as to the purchase from that EWG, which would mean that to the extent that we authorize a new power, that that power would be limited by the right of veto.

Now, it does not go back and fix the law as it relates to the Grand Gulf case, which is not a problem created by this act—which, by the way, is a very, very difficult problem to fix—but it would fix any problems created by the EWG situation.

Senator WELLSTONE. That is helpful.

Dr. COOPER. I just wanted to add one point. It is important not to argue that power pooling is synonymous with registered holding companies. That is, you do not have to have the integration or unification of ownership in order to have efficient pooling, so one of the things we might want to encourage is expansion of pooling for efficiency purposes, but that does not only happen within registered holding companies.

The complaint here is that if someone tries to get into the holding company, you will disrupt the pooling. Pooling takes place outside of holding companies. They can accommodate EWG's through pooling agreements, so that the efficiencies of that sort of grid management are not dependent upon ownership and planning in one corporate entity.

Mr. PATRIZIA. Senator, let me just add to that. Dr. Cooper is correct that pooling occurs outside of the holding company context. What he does not add there—and I think it is important to emphasize—is that pooling agreements are subject solely to FERC authority.

The whole point here is that the reason for that is that once you start making those kinds of wholesale power decisions and making them among a regional grouping because that is the most efficient and effective way to do it, you have a Federal issue.

It is not a State-by-State issue, and if you are going to give a State-by-State veto, you are going to lose the very efficiencies that you are trying to achieve. You are going to make it very difficult for EWG's to sell to registered holding companies and make it very difficult for those kinds of efficiencies to be realized.

Senator WELLSTONE. Mr. Chairman, I will not keep questioning, but Ms. Eckert kind of had her hand up, and as a teacher I am pretty sensitive to that, if we can let her comment.

Ms. ECKERT. Thank you. I grew up in Hastings, Minnesota, which is just a few miles from Northfield, from where you hail.

But just on a clarification on a reading of Mississippi, California really does not feel that Mississippi Power & Light will take away our jurisdictional rule on whether it was prudent for a State to include a portion of a FERC-regulated rate in their retail rate.

There are some nuances in Mississippi that the difference is between the States regulating retail and the FERC regulating wholesale, and I think what is really instructive in my reading of Mississippi, if you go to the dissent in Mississippi, it is really key to point out that they are separating the issue of allocation from the issue of whether the costs allocated to a particular utility should be borne by its retail customers or by the utility stockholders. We really would like to retain the right to make that determination.

So through any of the refinements that this legislation has with respect to Mississippi, I think there is a very narrow situation where FERC has set an allocation of power for several subsidiaries in different States within multistate holding companies, otherwise FEG, for example, are going to argue this with us.

But FERC itself has stated that it does not have the authority to review the prudence from the wholesale buyer's point of view outside of a multistate situation, so we maintain that we still retain it, and it is instructive to read that dissent in the Mississippi case.

The CHAIRMAN. I was going to say, Mr. Patrizia, with respect to pooling with respect to nonregistered holding companies, would you not concede that it is at least—it may be slightly unclear, but the better position is that States retain the authority on prudence on those transactions?

Mr. PATRIZIA. Well, Senator, you leave me in the uncomfortable position of expressing a view on behalf of someone who is not my client, and therefore I am probably able to agree with you without any question at all, since my clients will not be affected by that.

But I want to add that there might well be different views expressed by others on that.

The CHAIRMAN. But the better view is that they retain that power?

Mr. PATRIZIA. I think it is clear that States have a great deal of jurisdictional authority over generation facilities in any context. Mr. Vince has seemed to indicate that all of that authority has somehow flowed away from the States as a result of the decision. I would emphasize that if you are going to build a generation facility, you are going to have to site it. Siting is still a State authority. It has always been a State authority.

The CHAIRMAN. You are talking about prudence, really.

Mr. PATRIZIA. On the prudence question, I think that at least up until the time that the Supreme Court clearly rules on that question there could be some doubt, but I think in general States clearly have a great deal of authority in that area.

The CHAIRMAN. Dr. Cooper, you said the result of this legislation would be to federalize a lot of these decisions. Can you tell me what powers are taken away from States that they now have by this legislation?

Dr. COOPER. It is not that it takes away powers, it creates transactions which the States do not have the power to regulate. That is, when you create these wholesale transactions, they are regulated at the Federal level. You create the opportunity, the inclination, the tendency to engage in more of those transactions, and perhaps less of other kinds of transactions.

The CHAIRMAN. Now, you do not think they have the power to—you have a utility that is regulated by a PUC now. You do not think the PUC has the power to approve the purchase under one of these contracts?

Dr. COOPER. In some contexts they do. Obviously, in the holding company context they may not.

The CHAIRMAN. Well, in the holding company context, but that is—that would not be created by this act. And if we put in the fix I just mentioned, that would fix that.

Dr. COOPER. Let me say that the absolute veto at the State level, by the individual State level is significant process. And that is something that I see as crucial to empowering the States.

On the purchase side, for entities that are not now registered holding companies, and subject to the MP&L ruling no matter how we interpret that, the States have the ultimate prudence decision on the purchase side. I am not contesting that.

The ultimate veto is excellent. It is the other side, with respect to those entities I worry about.

The CHAIRMAN. The registered holding companies?

Dr. COOPER. No, the creation of the selling entities.

States now have—as long as they remain intrastate—the capacity to regulate both the generation side and the distribution side, the retail side. There we have the problem of creating independent power producers who are domiciled—that is, the holding company parent is domiciled someplace outside the State. So you are back to the classic problems of a series of single subsidiaries.

The CHAIRMAN. All subsidies and——

Dr. COOPER. That is a third question. But let us just deal with the IPP's. Now, today an independent power producer cannot go into the business of building around the country subject to a holding company. They run into the Holding Company Act.

Under your bill, they would be able to.

The CHAIRMAN. Yes.

Dr. COOPER. How did the State get at that, in terms of regulation? That was a concern, a possible concern. The shifting of resources may be important there. In addition to that, then you have the added problem of affiliates.

So you have two layers of difficulty—structural entities created that did not exist yesterday, that pose a regulatory problem. Is there a regulatory authority?

The CHAIRMAN. You do not think a State commission could tell their utilities or condition the participation in an EWG?

Dr. COOPER. In some cases, the utilities have looked me right in the eye and say, we will not accept that because my State, today, does not have that authority.

The CHAIRMAN. Well, that is State law, that is not Federal law.

Dr. COOPER. The State does not need the law because there is Federal law that prevents, dissuades, and deters that activity. So what I would say to you is, let us require the State law first. Before we take away the Federal bar, let us say, State—in order to get the EWG—we are going to remove the Federal barrier so that this activity can suddenly grow.

The CHAIRMAN. Well, what is the Federal barrier, preemption?

Dr. COOPER. The Public Utility Holding Company Act prevents certain activity. So in some States there is law that does the same thing PUHCA does. In other States, there is not.

Let us say States should have that kind of law to regulate this activity in some fashion.

The CHAIRMAN. Mr. Boissiere, you are—we have not heard from you, and I would like to hear your view on this.

Mr. BOISSIERE. Well, I was not prepared to make a prepared statement, as such. But just in listening to the debate, I think that the best thing to look at is the Grand Gulf situation. That is exactly what happened.

This was a subsidiary that formed itself with Nuclear Regulatory authority approval, without FERC, then later on had to go to FERC. And FERC allocated so much back to the local entities that we had to accept it, and then put that cost into our formula for retail purposes.

So I think what appears to be happening is that you are trying to allow Grand Gulf to occur again. And I think you need to look at it very carefully before you do it.

The CHAIRMAN. No, precisely the opposite.

Mr. BOISSIERE. You are trying to prevent that from happening?

The CHAIRMAN. What I just suggested is—and I think we can come up with an amendment—that with respect to these new entities created under this act and EWG, that we would give the PUC's—in Louisiana in this case—an absolute veto so that they could not participate in that.

Now that might not fix all of the problem created under—not under this bill that we have, but under the present law, it might not fix all that. It does not fix a lot of things.

Mr. BOISSIERE. Well, veto would certainly have helped us at the appropriate time. It would have.

The CHAIRMAN. Well, it would not have—the veto I am talking about would not have made any difference in Grand Gulf, because this bill would not have created the problem of Grand Gulf.

But to the extent that this bill creates the authority to buy from EWG's, it—that kind of veto would be an absolute protection.

Mr. PATRIZIA. Mr. Chairman, could I add one point to that?

One of the first things I learned in law school was that hard cases make bad law. And if we are trying to create a circumstance under which we are going to protect against Grand-Gulf-sorts of situations, hard-case situations, we may well end up making bad law.

And I would urge the committee to think very long and hard about whether you are sacrificing the benefits you seek to achieve by trying to solve a problem that may well be much better and more simply solved by examining the regulatory structures and recognizing that in hard cases, there are going to be dissatisfied parties.

The CHAIRMAN. Well, I think Grand Gulf could not occur again, frankly, because of other reasons which we need not go into here, which are complicated reasons. And I do not think that could occur even under the Grand Gulf law. I am sure we would get some arguments on both sides from you and from Mr. Vince about that.

But if we put in this amendment giving the veto, it is a cinch that it could not occur with EWG's because of this bill.

You know, everybody wants to fix all the problems—Mr. Cooper wants to cure all the deficiencies of State regulatory law—and we talked this morning about giving a Federal mandate to the States—to those States that do not have it, and we will consider that.

But legislation is always a compromise. And I think it is a legitimate concern about Grand Gulf. And Mr. Giarrusso says he does not want New Orleans to get into a situation where they are—have one of these Grand Gulf type purchases created by an EWG purchase. I think that is a very legitimate concern.

I know Senator Bumpers feels that way. I think we can fix that. I think we can codify Pike County, which I have language that all of you all have seen to do that. Now I think that is a huge victory for the people of the New Orleans point of view. And I do not think it really unduly hurts registered holding companies. I know you disagree with that, Mr. Patrizia.

Mr. **Patrizia**. I disagree very strongly, Mr. Chairman. And there are some aspects of the language that I saw very recently that would not simply codify Pike County, but actually extend it, make it much more difficult for registered companies to have system agreements and all that sort of stuff. I mean there is a number of questions there. And I think——

The **Chairman**. Well, what I am talking about is in lieu of just have the narrow Pike County fix, plus the vetoes.

Mr. **Patrizia**. I understand that, Mr. Chairman. But when you say a narrow Pike County fix, language that I saw recently went beyond the determination of——

The **Chairman**. Well, let me give you the language.

"Nothing in this act or the Public Utility Holding Company Act of 1935, as amended, shall prevent a State commission from allowing or disallowing, in accordance with State law, the inclusion of the cost of electric energy purchased at wholesale and rates and charges subject to such State commission's jurisdiction."

Mr. **Patrizia**. That is exactly the problem that I was raising, Senator. Mr. Chairman, that language, as it stands, would mean that every system agreement among a registered company would now be subject to State disallowance. That would totally overturn 55 years of regulatory jurisdiction, over the pooling agreements and the system agreements in registered companies. That is not a Pike County fix.

The **Chairman**. Well, that language right there?

Mr. **Patrizia**. That language right there, Senator.

The **Chairman**. Well.

Mr. **Patrizia**. That is a big change from existing law, that is not a Pike County fix.

The **Chairman**. This language applies really to the—only to the nonregistered. And the veto would apply to the registered on purchases from EWG's.

Mr. **Patrizia**. The language, as I understood it, and I will be happy to work with staff to be sure that I am understanding it correctly, said that nothing in this act or the Holding Company Act would prevent a State from disallowing a purchase at wholesale.

Every system agreement is a purchase at wholesale. It involves the transactions among the affiliates for capacity and energy.

The **Chairman**. Well, I should—we should not talk about this language, probably, to show you the language—it is probably not fair to be reading it.

But I would hope that this suggestion fixes the problem. And we would like to hear further from any of you on that.

Did you have something to say, Ms. Eckert?

Ms. ECKERT. Just to support what you are saying, we would urge that, as that narrow Pike County fix, simply because it would go a long way to clarifying the Pike County doctrine in terms that FERC's jurisdiction under the Federal Power Act to set just and reasonable wholesale rates based on the seller's cost does not preempt us from reviewing the prudence of utility decisions to purchase the power under those rates.

That is what—there seems to be a little confusion here as to how a State gets a handle on whether that utility made a prudent purchase or not.

The CHAIRMAN. That is right. That is the general rule. It does not apply to registered holding companies. And that is what we intend to codify.

Ms. ECKERT. That would be—we would support that.

The CHAIRMAN. Senator Wallop.

Senator WALLOP. No thank you, Mr. Chairman.

The CHAIRMAN. Lady and gentlemen, thank you very much. You have been most helpful.

[Whereupon at 4:10 p.m., the hearing was adjourned.]

[Additional material for the record follows:]

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510-6150

March 13, 1991

MEMORANDUM

TO: **Members and Energy LA's**
Committee on Energy and Natural Resources

FROM: Bill Conway, Senior Counsel B.C.

RE: Hearing on Title XV of S. 341 -- Removal of Impediments to Independent Power Production Contained in the Public Utility Holding Company Act of 1935

On March 14 at 10:00 a.m. and 2:00 p.m. in Room SH-216 of the Hart Senate Office Building, the Committee on Energy and Natural Resources will hold a hearing on Title XV of S.341.

This memorandum provides background on Title XV, discussion of the issues raised by the legislation along with responses, and a section-by-section analysis.

I. SUMMARY

Title XV would remove the obstacles to independent power production contained in the Public Utility Holding Company Act of 1935 (PUHCA). The effect of this change would be to allow independent power producers (IPPs) to compete in wholesale power markets as a new supply option. By fostering market competition the legislation would help to ensure that electric generation is provided to consumers in the most efficient way possible and therefore at least cost.

For practical and financial reasons, the developer of an IPP (whether the developer is a utility or a non-utility) must generally create a separate corporate entity to do so. In turn, the developing party becomes a holding company. PUHCA, however, places extensive restrictions on the use of holding companies in electric generation. Without changes to the Act, most opportunities for IPPS are therefore precluded. Title XV would simply modify PUHCA so as to remove the limitation on the use of holding companies for independent power production.

I. THE CURRENT REGULATORY SITUATION

A. Problems With Traditional Cost-of-Service Regulation

Electric generation has traditionally been supplied on a monopoly basis by utilities subject to cost-of-service regulation. Under cost-of-service regulation, utilities are permitted to charge rates that allow them to recover their expenses plus a reasonable return on capital investment (rate base). Wholesale sales between utilities (sales for resale) are generally regulated by the Federal Energy Regulatory Commission (FERC) under the Federal Power Act. Retail sales (sales for consumption) are generally regulated by State public utility commissions.

Until the 1970's, factors affecting electric utilities were predictable; the real price of electricity declined; and cost-of-service regulation functioned fairly well. Since then, various changes (high real interest rates, unpredictability of demand, increasing construction costs to name a few) have raised concerns about the current system.

Cost-of-service regulation is intended to simulate the effect of a competitive market. In rough terms, a business in a competitive market expects to receive what cost-of-service regulation provides: recovery of expenses and a profit on capital invested. Nevertheless, in actual operation cost-of-service regulation creates a poor match of risk to reward. It gives utilities a chance of recovering all costs (because of the imperfect substitution of the judgment of regulators for competitors) while eliminating the possibility that gains from increased productivity can be kept (therefore removing the most potent incentive for efficiency). Or conversely, cost-of-service regulation can be used by regulatory commissions as an arbitrary device for heaping all risks on utilities and penalizing them unfairly.

B. Positive Experiments With Wholesale Power Competition Under PURPA

Until recently, it was thought that electric generation has the characteristics of a natural monopoly. That is, it was assumed that a single utility in a given market will always be able to reduce costs through economies of scale such that smaller competitors are driven out of business. Experience under the Public Utility Regulatory Policies Act of 1978 (PURPA) has provided reason to question this assumption.

PURPA created a special class of electric generating projects, known as Qualifying Facilities (QFs). QFs must be either cogeneration facilities (facilities that produce electricity and useful thermal energy) or small power production facilities (facilities whose primary energy source is solar, hydropower, waste, biomass, wind or other renewable resources). Both kinds of QFs receive various advantages. The most important of these are: 1) exemption from the Federal Power Act, the Public Utility Holding Company Act of 1935, and state utility regulation; and 2) a requirement (subject to certain conditions) that utilities purchase power offered by QFs at each utility's "avoided cost", the cost that a utility avoids by not generating the power itself or purchasing it elsewhere.

Contrary to original expectations, PURPA has produced an explosion of QF development (approximately 30,000 MW). This process has occurred under increasingly competitive conditions. In the early years of PURPA, State utility commissions (who are charged with implementing the Act) tended to set avoided cost rates for the purchase of QF power at excessively high levels. However, as QFs began to be able to offer more capacity than utilities needed, State commissions began to allow rates paid for QF power to be negotiated down below the purchasing utility's own avoided cost. More recently, a growing number of States (20 by last count) have adopted, or are in the process of adopting, bidding programs for the acquisition of QF capacity by their native utilities.

In bidding programs, avoided costs prices effectively amount to market rates because they are set through direct competition between QFs and any other competing sources of supply. Bidding programs to date have exhibited a high degree of competition among suppliers. Typically, they have resulted in prices and conditions that, for various reasons, are better for ratepayers than what the purchasing utility can offer. While the track record of bidding is not yet well established, it provides some empirical basis for believing that competition in wholesale power markets can benefit consumers significantly. This result is not surprising. Orthodox economic theory generally holds that workable competition is a superior alternative to regulation.

There are, however, practical problems with future reliance on QFs under PURPA as a significant supply source. For small power producers, limitations on the economics of renewable resources means that at present these sorts of QFs cannot make major contributions to power needs. Future development of cogeneration is becoming increasingly restricted as available steam hosts are used up. Moreover, the steam hosts that do remain are not necessarily located near electric demand, and the timing of their operational needs for steam may conflict with the timing of a utility's need for power from a cogeneration facility.

III. WHAT IS AN INDEPENDENT POWER PRODUCER (IPP)?

Given the possibilities for competition demonstrated by PURPA, a logical step would be to allow such competition to take place free of the technological restrictions of QF status. In addition, it would make sense in a competitive context to remove two of the other distorting aspects of the PURPA regime: restrictions on ownership of QFs by utilities and the facial requirement that utilities purchase all power offered by QFs. In essence, what is left after these changes are made is the concept of an Independent Power Producer (IPP).

In general terms, an IPP is a person (utility or nonutility) who owns a wholesale generating facility and who, because of a lack of market power, is permitted under the Federal Power Act to charge a market-determined price for electricity that the facility produces. Lack of market power in this context would mean either that: 1) the IPP is not selling to an affiliated company and does not control transmission access to potential buyers of power from the facility; or 2) the IPP is selling to an affiliate, or it controls transmission access to the buyer, but abuse of market power is prevented through regulatory oversight or conditions (example: A market-priced power sale between affiliates is approved because the rate is below a similar arms-length transaction between the affiliate-buyer and an unaffiliated entity). These conditions for being an IPP (and therefore being entitled to charge market rates) have been established by FERC in a series of case rulings.

III. THE NEED FOR CHANGES TO THE HOLDING COMPANY ACT

A. How Does PUHCA Prevent IPP Development?

The QF experience under PURPA suggests that consumers could benefit from the existence of IPPs as a supply option. The need for such an option is more than theoretical. A growing number of analysts predict large demands for new generation in the 1990s and note with alarm that much of it has not been planned. Moreover, there are at this moment a number of willing utility buyers and willing sellers (both utility and nonutility) for IPP projects who are stymied in their efforts. The obstacle standing in the way of these projects is not the need to get FERC approval for market rates, but the effective bar posed by the Public Utility Holding Company Act of 1935.

As a practical matter, IPP projects generally must be developed in a holding company format, whether they are to be developed by utilities or nonutilities. First, there is general consensus that the financial markets will require IPPs to be project financed. That is, debt lenders will provide capital only if it is secured by a corporate entity which controls project assets and revenues. Equity participants in turn will demand that their liability be non-recourse (i.e. limited to the value of project assets). The only effective way for these requirements to be met is by creating a separate corporate entity to develop an individual project and thus turning the equity owner into a holding company. Second, for reasons of organizational convenience, corporations generally desire to separate different lines of business into separate subsidiaries, again requiring a holding company structure. Third, to the extent that utilities develop IPPs, regulators will generally require the creation of separate subsidiaries for purposes of risk separation and cost accounting.

Unfortunately, the ownership of an IPP in a holding company format generally makes the parent owner (and its IPP) subject to the Holding Company Act. Under PUHCA, when a corporation owns more than ten percent of a separate corporate entity engaged in the business of electric generation (i.e. an IPP), it generally becomes a "holding company" subject to the provisions of the Act. All holding companies under the Holding Company Act must either become "exempt holding companies" or "registered holding companies."

As the name implies, exempt holding companies are not subject to most provisions of the Holding Company Act. However, in order to be exempt, a holding company must meet one of five criteria set out in section 3 of PUHCA. These criteria variously restrict a holding company's geographical scope of operations, its ability to be engaged in anything other than utility business, or its ability to be engaged in the utility business itself. In addition to the narrow focus of these criteria, other provisions of the Holding Company Act restrict utility (i.e. IPP) acquisitions by exempt companies and give the SEC (which administers the Act) discretion to revoke an exemption in the public interest. Thus, status as an exempt holding company offers only very limited opportunities for IPP development.

In the case of registered holding companies, PUHCA is considerably more restrictive. For those companies that are not currently registered, the burdens of such status effectively preclude it as an option. Among other provisions, the Holding Company Act pervasively regulates the issuance and acquisition of securities by registered companies, requires registered companies to be operated as integrated utility systems, generally prohibits the ownership of utility and nonutility businesses which are not related to the operation of an integrated system, and requires simplification of corporate structures. Even for those companies that are already registered, the provisions of the Act requiring operation as an integrated system and restricting entry into unrelated businesses effectively prohibit most opportunities for IPP development.

In short, whether one is a non-utility, a simple investor-owned utility, an exempt holding company, or a registered holding company, the Holding Company Act stands as a practical bar to most opportunities for IPP development. While there are a few ways in which the restrictions of the Act may be circumvented, they have limited use. Thus, most positive opportunities for competition in wholesale power generation will be lost without changes in PUHCA.

B. Why Did Congress Restrict the Use of Holding Companies in the First Place?

In 1935 control of the electric utility industry was concentrated in a few large holding companies whose operations were abusive to investors and ratepayers. Problems included excessive profits from transactions between affiliates, issuance of securities on the basis of unsound asset values, statements of earnings based on paper profits from affiliate transactions, and the use of inconsistent accounting practices.

PUHCA was enacted in order to curb these corporate abuses. It does so largely by restricting the use of holding companies. The basic concept of the Act is that the use of holding companies is only justified in order to achieve savings from electrical integration (operation of multiple utilities as a system). Thus, the Act imposes what amount to geographical proximity requirements on holding company operations (i.e. one can't operate an electric holding company in widely separated states because electric integration is not possible).

These geographical restrictions rest on the implicit assumption that the generation of electricity is a natural monopoly. In a world in which competition between different providers of generation is not possible, there is no need for holding companies to be able to operate on a geographically dispersed basis. However, as previous discussion makes clear, the natural monopoly character of generation is doubtful, and increased competition in wholesale power cannot go forward without changes to PUHCA.

C. Does Title XV Create the Risk That The Abuses That Led to Enactment of PUHCA Will Return?

Title XV makes limited changes in PUHCA which are comparable to the exemption of QFs from PUHCA under existing law. However, the abuses that led to the enactment of PUHCA are unlikely to return regardless of the changes that are made. When PUHCA was enacted in 1935, the two federal securities acts had only just been enacted, and the Federal Power Act was enacted as part of the same legislative package. State utility laws were in their nascent stages and in some cases did not even exist. Since then the regulatory regimes created by these statutes have come into their own and to a large extent provide duplicative protections to those contained in the Holding Company Act. The Holding Company Act in turn has become somewhat superfluous.

IV. How Does Title XV Deal with the Need for IPP Developers to Use Holding Company Structures Under PUHCA?

Title XV creates a new class of corporate entities known as "exempt wholesale generators" (EWGs) that are exempt from PUHCA in the same way as QFs under PURPA. In general terms an EWG is any entity that is engaged exclusively in the business of wholesale generation. Title XV provides that non-holding companies (both utility and non-utility) and exempt holding companies are permitted to own EWGs without restriction under PUHCA. The ownership of EWGs by registered holding companies is made subject to certain existing protections against cross-subsidy. (See VI below.)

Note that, as defined, there is nothing that requires an EWG to actually be an IPP (i.e. be permitted to sell power at market rates under the Federal Power Act). An EWG could conceivably sell power under traditional cost-of-service regulation, although market pricing is more likely to be the motivating factor for EWG creation. Title XV is intended to deal with the corporate organizational problems faced by IPP developers. These problems exist only under PUHCA and, strictly speaking, are entirely separate from the question of whether a given company can sell power at market rates.

V. If Utilities Are Allowed to Own IPPs Won't They Engage in Abusive Self-Dealing with IPP Affiliates?

Power transactions between utilities who are affiliates of each other are not unusual under existing law. However, they generally take place under cost-of-service regulation which, by its structure, prevents the abuse of market power. The real concern with self-dealing arises over the possibility of market pricing between utility affiliates. FERC, however, has made it absolutely clear that a seller carries a heavy burden if it seeks to receive market pricing for a sale of wholesale power to an affiliate. To date the Commission has only approved one such sale. Moreover, in most situations a State commission will have the independent ability under State law to disallow the passthrough in retail rates of the costs of wholesale purchased power by a local utility when the commission deems such purchase imprudent. (However, see discussion under VIII below.) Thus, by imposing regulation on both sellers and buyers, existing law effectively addresses the potential problem of self-dealing in power transactions. Finally, it is important to realize that in changing PUHCA, Title XV does not affect the self-dealing issue in any way since PUHCA deals with corporate matters rather than power transactions.

VI. If Utilities Are Allowed to Own EWGs Won't This Result in Cross-Subsidies By Captive Ratepayers in Favor of a Utility's Unregulated EWG?

Some parties have raised the concern that utilities may use their captive ratepayers to cross-subsidize their unregulated EWGs. Cross-subsidy would occur, for example, if a utility's engineering department performs services for the utility's EWG but charges the cost of those services to retail ratepayers, or if the utility guarantees the debt of its EWG and thereby puts its ratepayers at risk of financially supporting its unregulated operations. Such actions are objectionable because they put retail ratepayers in the position of paying for matters that only benefit a utility's shareholders.

Under current law, PUHCA only regulates cross-subsidy issues with respect to registered holding companies. Title XV follows this distinction. The legislation generally treats an EWG owned by a registered holding company like any other registered holding company affiliate. The protections that apply include: 1) SEC approval of securities issuance by the registered company for purposes of financing an EWG; 2) SEC approval of the guarantee of any of the EWG's securities; 3) SEC approval of service, sales or construction contracts between the EWG and the registered company or any of its affiliates; and 4) a requirement that any such contracts be performed at cost.

PUHCA does not address cross-subsidy issues with respect to exempt holding companies (the other category of holding companies regulated by the Act), and neither does Title XV. The assumption of PUHCA (and of Title XV) is that, by virtue of the criteria for achieving exempt holding company status, these matters are within the power of State commissions to regulate under State law. State commissions do in fact regulate cross-subsidy matters involving exempt holding company operations to varying degrees, as well as those involving non-holding company utilities.

VII. Title XV Is Intended to Foster Wholesale Power Competition. How Can There Be Any Competition If EWGs Are Not Guaranteed Transmission Access?

Under current law, FERC generally has exclusive authority under the Federal Power Act over rates, terms and conditions for transmission service by utilities. The provision of service is largely voluntary.[1] Critics of Title XV have argued that competition in wholesale generation is not possible if transmission access remains voluntary because sellers will not be able to get their power to potential buyers.

Experience conclusively rebuts this assertion. In competitive bidding under PURPA, virtually every solicitation thus far has attracted at least ten megawatts offered for every megawatt needed. While the potential for new QF projects must eventually be exhausted (thus making PUHCA reform desirable), the results of bidding to date indicate that vigorous competition can be achieved without altering the existing transmission regulatory scheme. The reason for this success stems from the fact that:

> 1) In any given instance, many of the cost effective opportunities for competitive generation can be sited within the service territory of the purchasing utility, thus enabling direct interconnection and obviating the need for any transmission by a third party; and
>
> 2) Utilities are in fact providing significant transmission services to bidders under current law.

As of February 1991, 161 QF and independent power projects representing 9205 megawatts had been selected as winners in competitive bidding. 44 of those projects, representing 3657 megawatts, were dependent upon the provision of transmission services.

58 of the winning projects, representing 1348 megawatts, have gone into operation. Seven of these on-line projects, representing 606 megawatts, are receiving transmission service from utilities.

30 of the 161 winning projects have been canceled. Of these 30 projects, only 3 projects representing 324 megawatts were canceled because of an inability to obtain transmission access.

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[1] However, transmission access can be ordered : 1) as a possible consequence of violations of antitrust laws or policies; 2) as a condition of utility merger under section 203 of the Federal Power Act; 3) after satisfaction of fairly onerous threshold determinations under Sections 211 and 212 of the Federal Power Act; 4) as a condition of receiving market pricing for wholesale power where the seller controls transmission access to the buyer; and 5) possibly as a condition of a State approval under State law (for example: with respect to construction of new transmission).

The remainder of the winning projects are still in the development stage.[2]

A fair analysis of this data strongly suggests that the existing transmission regulatory regime (though perhaps less than perfect) is not a significant obstacle to successful competition and project completion.

Moreover, where problems do exist there are strong reasons not to address them by simply mandating the provision of wholesale transmission access on a comprehensive basis. The provision of transmission service is technically complex. Electricity follows the route of least resistance on transmission lines rather than the shortest distance between two points or the economically desirable pathway. It must be produced more or less simultaneously with its consumption. Under an alternating current (AC) system (as ours generally is), a given utility must operate its facilities in synchronization with all others to which it is interconnected. A transmission system must always be managed with a view towards the maintenance of service in the event of multiple line failure. Because of these factors and others, the provision of transmission service is anything but simple from a technical standpoint.

The economic issues raised by any comprehensive address of transmission access are no less daunting. Should a utility with limited transmission capacity be forced to sacrifice its off-system economy energy sales so as to be able to provide transmission service to a requesting party? Should a party requesting transmission service be required to pay the capital cost of any system upgrades that the provision of such service would make necessary? If so, does the party receive a permanent and transferable right to a portion of the utility's transmission capacity? Generic questions of this type abound with respect to transmission, and there is little consensus concerning the answers.

At the same time, market forces seem to be driving utilities to provide more and more transmission access on a voluntary basis. For example, the Western Systems Power Pool (WSPP), comprising most of the utilities in the western United States, has recently asked FERC to make permanent an experimental market pricing scheme for short term energy sales. In return for such approval the member utilities of the WSPP are willing to provide long term transmission service to the extent of available capacity.

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[2] Robertson's Current Competition, Vol.2 No.4 (February 1991), supplemented by conversations with the publisher.

Given the overwhelming number of issues that must be resolved if transmission is mandated on a comprehensive basis, it would seem to make more sense to allow the transmission issue to follow its current path of gradual evolution.

VIII. WHAT ARE THE CONCERNS OF STATE REGULATORS WITH RESPECT TO TITLE XV?

FERC has exclusive authority under the Federal Power Act to set rates and charges for wholesale sales of power. However, under what is known as the Pike County doctrine[3], a State utility commission generally retains the right under State law to review wholesale power purchases by its native utilities and to disallow the passthrough of the costs of purchased power in retail rates if the commission finds a purchase to be imprudent. In effect, FERC generally regulates wholesale sellers, and State commissions regulate wholesale buyers.

The concern of State **commissions** lies with an apparent exception to this general relationship between Federal and State utility regulation. Under the Supreme Court's Mississippi decision[4], FERC may prescribe cost allocations and preempt the right of State commissions to review the prudence of power transactions in cases involving wholesale power transactions among the utility subsidiaries of registered holding companies. State commissions who regulate registered holding company subsidiaries seek some change in the law that would give them input into these preempted matters. Remaining State commissions fear that the Mississippi decision casts some doubt on the general validity of the Pike County doctrine and seek clarification of the law. Both groups conclude that enactment of Title XV will encourage wholesale power transactions and thus exacerbate State-Federal tensions under existing law.

A workable resolution of these concerns must reconcile the desire of State commissions to have appropriate oversight of the purchasing activities of registered holding company subsidiaries with the legitimate need of registered holding companies not to be subject to inconsistent decision-making by different State commissions.

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[3] The Pike County doctrine takes its name from a State court case, Pike County Light & Power Co. v. Pennsylvania Public Utility Comm'n, 465 A. 2d 735 (1983).

[4] Mississippi Power & Light Co. v. Mississippi ex rel. Moore, 108 S. Ct. 2428 (1988).

IX. Won't EWGs Be Highly Leveraged With Debt? Isn't Leverage Financially Risky? Will Leverage by EWGs Hurt the Credit Ratings of Utility Power Purchasers?

Leveraging is the use of capital structures that employ a high proportion of debt (bonds and other promises to repay borrowed funds with interest) relative to equity (stock and other forms of ownership. QFs under PURPA have generally used leverage on the order of 80 or 90 percent debt. The handful of IPPs that have managed to avoid problems with PUHCA have been similarly structured. It is therefore reasonable to expect EWGs to employ leverage as well. QFs, IPPs and EWGs are referred to collectively in this discussion as non-utility generators or NUGs.

NUGs, like all businesses, seek to minimize their cost of capital. Debt leverage is used by NUGs because that is what the capital markets have determined is the most efficient way of financing them. It appears that leveraging by NUGs may confer a cost advantage relative to utilities' cost of capital in some instances, but that the advantage is not consistent or inherent. Moreover, where it does exist, the cost advantage of leveraging frequently seems to be insignificant.

There is nothing inherently imprudent about the use of leveraged capital structures to finance a business. Leverage does mean, however, that a high proportion of a business' cash flow must be devoted to making interest payments. This obligation in turn limits the ability of the business to deal with unforeseen increases in cost or decreases in revenues. Businesses for which leverage is suitable are those with predictable revenues and tangible assets whose value is known.

NUGs appear to meet these criteria. Typically, they will be single asset enterprises (one generating unit) having single, long-term power sales contracts. The factors affecting the ability of a given generating unit to produce power can be assessed with relative certainty and the risks of failure minimized. The power contract for a NUG will generally require the utility to pay for a specified amount of power produced, thus enabling cash flow to be accurately projected.

Some critics have asserted that the use of leveraging by NUGs will cause rating agencies to attribute the cost of power contracts with NUGs as debt on the purchasing utility's balance sheet, thereby lowering the utility's credit rating. Rating agencies have in fact noted that power contracts with NUGs can lower a purchasing utility's financial flexibility (i.e. cash flow committed under a power contract is unavailable for unforeseen contingencies). Moreover, in at least one instance a rating agency appears to account for this effect by treating the power contract as debt. However, it should be recognized that reduction in financial flexibility is strictly a consequence of entering into a long-term power purchase contract. It has nothing to do with whether the seller under the contract is a NUG or is leveraged. The same concern exists with respect to a long term power contract between two utilities.

More importantly, reduction in financial flexibility is only one of a host of costs and benefits that the rating agencies will examine in determining the effect of a power purchase contract with a NUG on a utility's credit worthiness. In general terms, the agencies evaluate a contract on the basis of whether, and to what extent, it allows the utility purchaser to spin off significant risks (such as the risk of construction or operation of a plant) on to the seller. Rating agencies have explicitly recognized that a power contract with a NUG may offer either a significant benefit or a significant detriment to the purchasing utility. The answer in any given circumstance will depend for the most part upon what the contract provides. Examples of factors that the rating agencies look at include whether the NUG is dispatchable, whether it contributes to fuel diversity, and whether the operator has a previous track record.

A more detailed discussion of debt leveraging and NUGs has been prepared in a separate staff memorandum.

X. SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 15001

subsection (a)

Title XV uses the term "Exempt Wholesale Generator" (EWG), rather than IPP, to designate entities exempt from PUHCA in order to clarify that the legislation is dealing only with structural problems in PUHCA. The term "IPP" generally denotes an entity that receives market pricing under the Federal Power Act. Since the legislation does not deal with market pricing it adopts different terminology for purposes of clarity.

Under paragraph (1), an EWG is basically a corporate person who is engaged exclusively in the wholesale generation business. Section 2(a)(11)(B) of PUHCA mentioned in paragraph (1) references downward affiliates. Thus, for purposes of the legislation an EWG could be an "EWG holding company" as well as an individual EWG affiliate engaged in developing specific projects.

The definition of an EWG has been drafted so as to permit an EWG to sell wholesale power that it has not necessarily generated itself. It appears that buyers of wholesale power may frequently desire to purchase capacity in increments that exceed what the most economical unit would produce. Consequently, the legislation would permit an EWG, for example, to generate 350 MW and purchase an additional 50 MW in order to meet a purchaser's 400 MW capacity need.

Paragraph (1) excludes affiliates of a registered holding company that are in existence as of the date of enactment from being EWGs, unless the SEC consents. Without this provision a number of existing affiliates of registered companies would automatically become exempt from the Holding Company Act upon enactment and thus be able to circumvent the approvals required for affiliates of registered companies under subsection (e).

EWGs may only own "eligible facilities". Under paragraph (2) of subsection (a), an "eligible facility" is any generating facility which is used exclusively for wholesale generation and for which any regulatory approvals required under paragraph (3) have been obtained.

Paragraph (3) requires approval from the state regulatory authority of any state in which a facility is in retail rate base or generating retail construction work in progress (CWIP) as of date of enactment. In most cases state law is likely to require such approval independently, but it is not clear that this will be true in all cases. Thus, approval is required under the legislation so as to ensure that ratepayers are not disadvantaged by a change in the status of a facility that has received financial benefits (i.e. CWIP or rate base treatment) based on the assumption of dedicated service to such ratepayers. The problem dealt with in paragraph (3) does not arise in the case of pre-existing wholesale facilities because it is clear that any change in the status of such facilities requires FERC approval under the Federal Power Act.

Finally, for purposes of subsection (a) a "facility" includes a portion of a facility. Thus, a given generating unit could produce power for sale at wholesale and retail, and the undivided portion producing wholesale power could be an "eligible facility" owned by an EWG.

subsection (b)

Subsection (b) exempts EWGs in their corporate personalities from all provisions of PUHCA. By providing that an EWG is not an "electric utility company" under PUHCA, the legislation also ensures that a company, which is not currently subject to PUHCA, cannot become subject to it by owning an EWG. This follows because the Holding Company Act only regulates "holding companies", and a holding company is defined in relevant part as a company that owns an electric utility company.

subsection (c)

For exempt holding companies, the chief obstacle to the ownership of EWGs (other than problems covered in subsections (a) and (b)) is the restrictive terms of exempt status as provided in section 3 of PUHCA. Subsection (c) simply makes it clear that section 3 and related provisions do not bar EWG ownership by exempt holding companies.

subsection (d)

Subsection (d) provides that a registered holding company may without further condition under PUHCA acquire an EWG. In the absence of this provision, the acquisition by a registered company of any securities or interest in any business would require SEC approval.

subsection (e)

Subsection (e) provides that if a registered holding company wants to: 1) issue securities (e.g. common equity) for purposes of financing an EWG; 2) guarantee the securities (e.g. debt) of an EWG; or 3) enter into service, sales, or construction contracts, or other relationships with an EWG (other than mere ownership), such actions remain subject to the SEC's existing jurisdiction under PUHCA, except that the provisions of section 11 of the Act are effectively negated for such purposes.

Section 11 requires each registered company to be operated as an integrated system and requires all of a registered company's businesses to be "functionally related" to integrated system operation. In the absence of section 11's prohibitions and policies, any approvals required under PUHCA for the creation of relationships between a registered company and an EWG will be made under the SEC's remaining authorities.

One of the advantages available to EWGs is the use of leveraged capital structures (i.e. those with a high proportion of debt) as a possible means of lowering overall capital costs. Typically, non-utility generation to date has employed such leveraging. The intention of title XV is that EWGs owned by registered holding companies have this same opportunity on equal terms. As a matter of regulatory policy, the SEC has generally required registered companies to maintain a 65% debt-equity ratio on a consolidated basis. It is assumed that the SEC will take into account the generally higher debt ratio of EWGs and in considering the consolidated balance sheet of a registered company not automatically and inflexibly apply the 65% ratio. In particular it would not make sense for EWG debt which is non-recourse with respect to the registered holding company or its utility affiliates to be considered by the SEC in applying the 65% ratio to the consolidated balance sheet. If there are indications after hearing that the SEC will not be flexible in its consideration of these issues, changes in the legislation may be required.

Finally, the Holding Company Act has always been interpreted by the SEC to exclude regulation of electric power sales since such transactions are regulated under the Federal Power Act. The legislation assumes this continuing interpretation.

Section 15002

PURPA limits ownership of QFs to persons not primarily engaged in the generation of electricity (other than by means of QFs). Under FERC's interpretation of this provision, electric utilities may own no more than 50% of a QF. Section 3 ensures that a non-utility company which acquires an exempt wholesale generator is not forced to divest itself of 50% of an existing QF, and is not limited in its ability to own 100% of a new QF, as a result of an argument that it has become primarily engaged in the generation of electric power.

Section 15003

Section 15003 creates a mechanism by which electric utilities can insulate themselves from being required to purchase power from EWGs. Under this section, a utility may from time to time elect to file a declaration with FERC. Upon filing, the utility is irrevocably prohibited from purchasing power from EWGs during the period specified in the declaration (but no longer than ten years). State commissions are prohibited from directly or indirectly penalizing a utility, or any of its affiliates or associate companies, for filing such a declaration. During the period in which a declaration remains in effect, a filing utility and its affiliates and associate companies are prohibited from owning EWGs or making any offers to sell power from EWGs that they might acquire after such declaration goes out of effect. The provisions of section 15003 are subject to enforcement under the Federal Power Act.

Section 15004

Section 15004 is a savings provision which generally maintains the existing division between federal and state jurisdiction over electric transactions. At present, the precise boundaries between federal and state jurisdiction are murky in situations involving registered holding companies. As a result states fear encroachment by FERC into their ratemaking powers. With the exception of matters reserved by section 15003, section 15004 makes clear that the jurisdictional status quo, such as it is, remains unchanged. Given the fact that section 15003 deals only with EWGs and that EWGs will only exist as a supply option if title XV is enacted, section 15003 does not amount to a true intrusion into existing state authority.

Section 15005

Section 15005 provides that references to "the Act" in Title XV are references to PUHCA. Section 15005 also provides that terms used in Title XV and defined in PUHCA shall have the meanings defined therein.

Alliance for Affordable Energy

Environmental Action

Government Accountability Project

Greenhouse Crisis Foundation

Greenpeace

National Consumers League

Nuclear Information and Resource Service

Public Citizen

Safe Energy Communication Council

SAFER-2

Sierra Club

U.S. Public Interest Research Group

TWELVE ENVIRONMENTAL, CONSUMER GROUPS URGE SENATE TO REJECT EFFORTS TO DRASTICALLY RESTRUCTURE PUHCA

For Release: Thursday - 10:00 am, March 14, 1991

Contact: Daniel Yoon, Public Citizen, 202-546-4996

WASHINGTON DC -- Twelve consumer and environmental groups today sent a letter to the members of the U.S. Senate urging them to reject changes to the Public Utility Holding Company Act being proposed by Senators J. Bennett Johnston (D-LA) and Malcolm Wallop (R-WY).

The groups warned that Johnston/Wallop proposals to amend PUHCA would result in an increased opportunity for utilities to engage in self-dealing, monopolistic practices, and cross-subsidization schemes. It would also allow utilities to circumvent state regulation and undermine state least-cost planning procedures, thereby resulting in higher utility rates for consumers.

This would provide utilities with an increased incentive to discriminate against competitors. Utilities would be able to offer favorable prices and give contracts to their own affiliates, employ other monopolistic practices to undercut competitors, and, in general, behave in an anti-competitive fashion. Thus, it would be harder for renewable and cogeneration supply sources, which are almost all independently owned, to compete.

The Johnston/Wallop proposal would allow utilities to by-pass state utility regulators and instead to shop for the most favorable forum they could find. This would facilitate the transfer of economic regulation of electric generating faciilities to the Federal Energy Regulatory Commission which is unresponsive to local consumer concerns and not particularly critical of costly energy sources such as nuclear power.

While noting the possibility that some changes to PUHCA may be beneficial, the groups stated that "given the potentially adverse conequences of poorly crafted reforms, these or any other amendments should be pursued cautiously. Moreover, we do not believe the Johnston/Wallop proposals are on the right track."

The groups concluded by asking the members of the Senate "to take a go-slow approach to any changes in PUHCA" and to reject the Johnston/Wallop proposals.

# # # # # #

A copy of the groups' letter is attached.

REJECT EFFORTS TO DRASTICALLY RESTRUCTURE THE PUBLIC UTILITY HOLDING COMPANY ACT

March 14, 1991

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Environmental Action

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National Consumers League

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Public Citizen

Safe Energy Communication Council

SAFER-2

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Dear Senator:

Senators J. Bennett Johnston (D-LA) and Malcolm Wallop (R-WY) have proposed (S.341, Title XV) a major restructuring of the Public Utility Holding Company Act (PUHCA). Their amendments would allow utilities to sell electricity on the wholesale market free of regulation and would institute other dramatic changes as well. The President's National Energy Strategy also contains provisions for wholesale revisions in PUHCA.

The rapid restructuring of the electric utility industry envisioned by S.341 could result in reduced competition in the wholesale electric market, increased consumers' utility rates, and a diminished ability by renewable energy facilities and energy conservation programs to meet future U.S. energy needs.

The undersigned consumer, environmental, and business organizations consequently urge you to oppose these proposals and any other efforts to put PUHCA "reform" on a fast track.

The Johnston/Wallop proposals to amend PUHCA, which Congress passed in 1935, would result in an increased opportunity for utilities to engage in self-dealing, monopolistic practices, and cross-subsidization schemes. It would also allow utilities to circumvent state regulation and undermine state least-cost planning procedures, thereby resulting in higher utility rates for consumers.

Specifically, S.341 would create a new class of electric generating companies that would be exempt from PUHCA and could be owned entirely by utilities. These affiliates, in turn, could sell power back to their utility owners at greatly inflated rates.

This would provide utilities with an increased incentive to discriminate against competitors. Utilities would be able to offer favorable prices and give contracts to their own affiliates, employ other monopolistic practices to undercut competitors, and, in general, behave in an anti-competitive fashion. Thus, it would be harder for renewable and cogeneration supply sources, which are almost all independently owned, to compete.

Furthermore, if the emerging renewable energy industry is to thrive, it must have access to the markets on the same basis as utility affiliates. However, current utility control of transmission lines, the highways of commerce in the electricity industry, could be used to further restrict competition.

Least-cost electrical planning would also become far more difficult, if not impossible. In recent years, states have begun to require utilities to reduce demand through implementation of conservation and improved energy efficiency programs, rather than building new capacity.

The Johnston/Wallop proposal would allow utilities to by-pass state utility regulators and instead to shop for the most favorable forum they could find. This would facilitate the transfer of economic regulation of electric generating faciilities to the Federal Energy Regulatory Commission which is unresponsive to local consumer concerns and not particularly critical of costly energy sources such as nuclear power.

Not surprisingly, the nuclear power industry sees PUHCA "reform" as essential to its revitalization because it would enable builders to escape state review of their plant construction plans.

PUHCA restructuring would also lift the historical ban preventing fuel suppliers, such as coal companies, from building power plants.

Tampering with PUHCA could therefore aggravate environmental problems such as radioactive waste, acid rain, and global warming by encouraging the construction of more large-scale and costly nuclear and coal-fired plants. This would likely be done at the expense of investing in more environmentally sound renewable energy facilities and programs to improve energy efficiency.

There are some changes to PUHCA, though, that could prove beneficial. For example, amendments that enable "true independents" -- those not affiliated with utilities, or with construction companies, oil corporations, and so on -- to enter the power generation industry more freely may be desirable.

Other changes might be appropriate if they improved the regulatory process while simultaneously protecting the interests of citizens and state governments. For example, modifications could be made to help more states and federal power marketing agencies develop and implement least-cost planning programs or promote the development of renewable energy and energy conservation.

However, given the potentially adverse conequences of poorly crafted reforms, these or any other amendments should be pursued cautiously. Moreover, we do not believe the Johnston/Wallop proposals are on the right track.

Consequently, we urge Congress to take a go-slow approach to any changes in PUHCA. We ask you, therefore, to reject the proposals presented in Title XV of S.341.

We would be happy to discuss this issue with you further.

Sincerely,

Gary Groesch
Executive Director
Alliance for Affordable Energy

Leon Lowery
Legislative Representative
Environmental Action

Richard Condit
Counsel on Environmental Issues
Government Accountability Project

Jeremy Rifkin
President
Greenhouse Crisis Foundation

James Riccio
Nuclear Power Campaign Coordinator
Greenpeace

Linda Golodner
Executive Director
National Consumers League

Michael Mariotte
Executive Director
Nuclear Information and Resource Service

Ken Bossong
Director
Public Citizen's Critical Mass Energy Project

Scott Denman
Director
Safe Energy Communication Council

William Holmberg
President
SAFER-2

Melanie L. Griffin
Washington Director, Energy Program
Sierra Club

Bill Magavern
Staff Attorney
U.S. Public Interest Research Group

AMERICAN BAR ASSOCIATION
SECTION OF NATURAL RESOURCES, ENERGY, AND ENVIRONMENTAL LAW

Who Needs PUHCA?

Presented by
Ronald E. Russell, Commissioner
Michigan Public Service Commission
March 8, 1991

In the controversy surrounding the push toward competitive wholesale electric markets, many voices are heard to say that the Public Utility Holding Company Act of 1935 (Holding Company Act or PUHCA) is archaic, no longer serving the public interest and actually impeding progress toward the "benefits of enhanced competition." One hears that the abuses of the 1930s are no longer prevalent and the flower of true competition is just waiting to unfold in the electric industry (if only PUHCA would get out of the way).

We, in Michigan, have had a unique opportunity to examine what the future might be like without the protections afforded by the Holding Company Act. The Public Utility Regulatory Policies Act of 1978 (PURPA) opened the regulatory-safeguard door when it permitted utility monopolies to create affiliated qualifying facilities without review under the Holding Company Act. Revisions to the Act, such as those proposed by Senator J. Bennett Johnston, would remove the door. In the next few minutes I would like to use the example of CMS Energy Corporation to illustrate the complexities and challenges that state utility regulators face when exemptions to the Holding Company Act are allowed. I will leave it to you to extrapolate from our experiences.

Before I get started, let me make it perfectly clear that I am speaking only for myself. The opinions and characterizations included in my remarks today are attributable only to me.

CMS Energy Corporation is a utility holding company with at least 40 subsidiaries and affiliates that we are aware of. The largest of these is Consumers Power Company which is a combination electric and gas utility with approximate annual operating revenues of $1.7 billion from 1.4 million electric customers and $1.1 billion from 1.3 million gas customers (1989 Annual Report). In a January 1991 press release, CMS Energy described itself as "a $3 billion (sales) diversified energy holding company with businesses engaged in the distribution of electricity and natural gas, interstate storage and transmission of natural gas, oil and gas exploration and production, independent power generation and utility services."

CMS Energy has an intrastate exemption from the Holding Company Act. This exemption, in combination with the exemption for qualifying facilities under PURPA, has the potential to produce an environment within which creative minds have ample opportunity to maximize shareholder profits at great expense to ratepayers of rate-regulated utility affiliates. With the exemption, corporate structure, and transactions between corporate affiliates, can be manipulated to embrace the concept of competitive generation while ensuring that all competitive advantages reside with holding company affiliates.

In the January/February, 1990 issue of The Electricity Journal, Bill Weeden of the Securities and Exchange Commission (SEC) staff walked the reader through a brief history of the abuses that led up to the enactment of the Holding Company Act. A comparison of a few of Mr. Weeden's examples with recent CMS Energy activities may be helpful in determining whether the Act is still germane.

> STATEMENT 1:
> "First and foremost, the holding company structure was a device by which state utility regulation was obstructed. Management and control were shifted from the operating public utility company, which was subject to state regulation, to the holding company often organized under the laws of another state and not within the jurisdiction of utility regulators in any state."

Forum shopping or forum avoidance, although long-practiced legal maneuvers, have always been frowned upon in the legal and regulatory communities. Although CMS Energy is incorporated in Michigan, since its creation, Consumers Power Company and affiliates, Midland Cogeneration Venture Ltd. (MCV), MEC Development Corporation, Palisades Generating Company (PGC) and others have missed few opportunities to challenge or avoid the jurisdiction of the Michigan Public Service Commission (Michigan Commission). We have been involved in over 30 court cases related to jurisdictional challenges from CMS Energy or its affiliates.

Consumers Power's inclination to avoid state jurisdiction is apparent even at the federal level. In the PGC rate case before the Federal Energy Regulatory Commission (FERC), Administrative Law Judge Samuel Gordon tied the FERC proceeding schedule to a Consumers Power Company filing with the Michigan Commission. Only after Consumers Power filed for necessary approvals in Michigan was the FERC case allowed to continue.

CMS Energy has used the holding company structure to interfere with state regulation of Consumers Power. Since becoming the utility's parent, CMS Energy and its unregulated subsidiary, CMS Enterprises Company, have actively opposed discovery, disclosure, and examination of their books and records. This has significantly complicated the Michigan Commission's ongoing investigation and monitoring of Consumers Power's financial stabilization program, as well as other efforts to ensure that transactions between Consumers Power and its affiliates are handled in an equitable manner.

The volume, complexity and expense of litigation related to CMS Energy's activities to date is unprecedented. It is commonly remarked that one of CMS Energy's strategies is to try and render the Michigan Commission ineffective by overloading our staff and legal resources. Other Michigan utilities have been heard to complain that they do not get timely attention to their issues because staff is tied up on the multitude of CMS-related cases. While we make every effort to ensure that all regulated utilities receive expeditious treatment of their applications, it is true that a disproportionate amount of resources are spent on efforts to regulate Consumers Power Company. This situation can only get worse if revisions to the Holding Company Act encourage all of our electric utilities to emulate Consumers Power Company.

> STATEMENT 2:
> "Holding company promoters did not confine their acquisitions of utility properties to any one geographic area or region;. . ."

CMS Energy has actively publicized its efforts to acquire an interest in utility plants in other states, such as Rancho Seco in California and Shoreham in New York. CMS is reportedly also pursuing utility opportunities internationally. With respect to its activities within Michigan, CMS Energy and/or its subsidiaries have become affiliated with many national and international corporations including Dow Chemical, Panhandle Eastern Corporation, Asea Brown Bovari, Fluor Corporation, Combustion Engineering and Bechtel Corporation among others.

> STATEMENT 3:
> ". . .with operating properties on both coasts and the Gulf of Mexico, the scattered service territories of these early holding companies often bore no economic or functional relationship to each other or to other businesses in the holding company system. The growth and profitability of the electric and gas utility industries afforded opportunities to holding companies to profit handsomely from intrasystem charges for management and engineering services and to issue securities based on inflated utility property prices, resulting in higher customer rates, to help finance further acquisitions."

Present day experiences with holding companies frequently reveal a slightly different twist to what occurred in the 1930s. Most of the regulatory conflict I have seen derives from functionally-related activities. While these activities may tend to appear somewhat less risky in that the utility is not venturing forth into areas about which it knows nothing, there is a significantly greater risk of diversion of management talent and attention, as well as other resources, to the non-regulated activity.

Opportunities for business transactions which favor holding company shareholders at the expense of utility ratepayers abound when officers of the utility also head up non-utility affiliates. In the case of CMS Energy, the same seven or eight names appear time after time as officers and directors of numerous affiliated entities.

The advent of cogeneration and competitive supply acquisition greatly magnifies the potential for excessive "intrasystem charges." The case record in U-8871, Midland Cogeneration Venture's application for approval of the power purchase agreement between itself and Consumers Power, clearly revealed an absence of arms' length bargaining between the two affiliates to the detriment of both the ratepayers and the non-affiliated cogenerators who hoped to sell power to the utility. By some coincidence, individual officers and managers appeared to bargain much harder when they were "wearing their affiliate hats" than when they were representing the utility in negotiations.

The terms of the contract between Consumers Power and MCV are too complex to go into here. Suffice it to say that the contract includes a number of unusual provisions that protect the MCV, rather than Consumers Power, in the event of any disallowances by the Michigan Commission. The contract also provides that if MCV ever loses its status as a qualifying facility, the MCV -- not the utility -- has the option of either terminating the contract or continuing to deliver capacity under a tariff regulated by the FERC.

After reviewing the litany of self-dealing abuses that characterized the record in the U-8871 proceeding, I, along with my fellow Commissioners, was moved to make the often quoted remark that ". . . one must wonder whether Consumers has once again negotiated with itself and lost." (U-8871 et al, Opinion and Order dated June 22, 1989).

Abuses were also found on the gas side. In U-8867-R, Consumers Power's 1988 Gas Cost Recovery (GCR) reconciliation, subsidies by Consumers Power of the MCV were found by the Michigan Commission. As an agent for the MCV, Consumers Power negotiated package deal contracts that inequitably allocated to the MCV certain benefits arising from the combined leverage of negotiating contracts for both companies with the same producers. A disallowance of unreasonable and imprudent gas costs of $2.5 million was ordered.

In testimony in U-9433, Consumers Power's 1990 GCR Plan, Commission staff analyzed the question of improper subsidization, and identified several aspects of what it calls unfair bargaining on the part of Consumers Power. Three significant improprieties are alleged by staff: 1) the timing of purchase obligations, e.g., Consumers Power was required to take the gas as soon as it was available, whereas the MCV was under no such obligation, 2) a price advantage for MCV over Consumers Power, e.g., weighted average gas acquisition costs were used in Consumers Powers' contracts and fixed escalators or coal-tied prices in the MCV's, and 3) the risk of significant changes in gas markets, e.g., the risk of a change from a buyers' market to a sellers' market is exclusively laid on the backs of the Consumers Power GCR customer through price reopener and contract termination clauses, while the corresponding MCV contracts do not contain any such provisions.

In addition to the potential negative rate impacts from holding company affiliate self-dealing, many allegations of anti-competitive behavior have surfaced. Practices such as inappropriate sharing of information between affiliates, denial of access to transmission services, prohibitive contract terms for non-affiliates (as opposed to more flexible terms for affiliates), and many other practices have been brought to light. (See article by Cindy Bogorad, "Self Dealing: The Case Against Removing PUHCA Restriction on Utility-Affiliated Power Producers," The Electricity Journal, Jan/Feb 1991.)

> STATEMENT 4:
> "These holding companies typically were highly leveraged and characterized by layer upon layer of partially-owned subsidiaries. The bulk of the capitalization of the holding-company system consisted of public non-voting debt and preferred stock. Consequently, effective control of extensive utility systems could be acquired with minimal equity investments by small groups of investors who exploited the subsidiary operating companies for their own gain at the expense of other investors and consumers."

With respect to the value of utility properties, a trend seems to be developing which would allow a non-regulated affiliate to benefit from the market value of a former utility asset, which was transferred to the affiliate at book value.

CMS Energy was formed in 1987 with no assets other than those that belonged to Consumers Power. Since that time, a process of decapitalizing Consumers Power to transfer assets to CMS Energy and affiliates seems to be underway. Two examples of this include the well-publicized Midland Cogeneration Venture, which is now a 1350 MW gas cogenerator with a contract to sell power to Consumers Power, and Palisades Generating Company (PGC), which is currently in the process of trying to become the nation's first nuclear independent power producer -- or more correctly -- affiliated power producer. The PGC is a corporation formed by Consumers Power, Bechtel and Westinghouse, to transfer the Palisades Nuclear Plant from Consumers Power to PGC and then sell power back to the utility under a seventeen year contract. Proceedings related to this project are presently underway before the FERC and the Michigan Commission. Applications for regulatory approvals have also been filed at the SEC and the Nuclear Regulatory Commission.

In addition to transferring assets away from the utility, we are seeing such things as decisions to retire non-mandatory preferred stock and thereby further reduce equity ratios even when the economics dictate otherwise (U-9594, U-9595). Such decisions could have the effect of providing greater control to shareholders of the holding company while increasing long-term ratepayer costs and exposure of the utility.

A recent complaint filed by Michigan's Attorney General in a Consumers Power securities case (U-9107) is typical of the allegations that have surfaced. In this case, the

Attorney General is arguing that Consumers Power does not need to issue additional securities because it would have sufficient funds if only it would quit transferring assets to non-regulated affiliates, exchanging liquid utility assets for less marketable instruments from CMS Energy and voluntarily diminishing its cash flow for the benefit of its parent.

In view of the kind of activities we've seen in Michigan, I find it extremely difficult to understand how Senator Johnston and other proponents of so-called "PUHCA reform" can deify the pursuit of competitive generation in the electric industry, while remaining apparently oblivious to the potential for interaffiliate abuses. Self-dealing and other anti-competitive activities not only could result in excessive retail rates, but also stand to subvert the new competitive regime by providing unwarranted subsidies and other advantages to a few "competitors" to the detriment of all others.

Some of you out there are undoubtedly thinking, "Hey, he's just made our argument for us: He's demonstrated that states can effectively uncover affiliate abuses and correct for them." To you, I have this to say: Relying solely upon after-the-fact rate reviews to protect consumers from utility holding company abuses is like trying to eat a meal with only one chopstick and both hands tied behind your back. You can be somewhat effective holding the chopstick with your feet and bringing food up to your mouth, but there are many foods that you won't be able to manage completely and more that you couldn't even attempt. State utility commissions can, and will, become virtuosos with our single chopsticks. However, we can only address what we can uncover and conclusively document.

The key to mitigating utility abuses is to prevent them from happening in the first place. The pre-acquisition reviews that are provided for in the Holding Company Act are intended to prevent the creation of corporate structures and transactions that are inherently susceptible to abusive behavior. The more complex the corporate relationships, the more difficult it becomes to detect abusive transactions.

Human nature has not changed since the 1930s. If the stage--or should I say table--is once again set for utility holding company abuses, those abuses will occur.

If Senator Johnston's goal is to have full and fair competition in the generation sector, I can support that goal. I recognize that government cannot legislate morality or corporate philosophy. However, if we are going to reshape regulation to encourage competition, let's encourage fair competition and not set ourselves up for a repeat of the abuses of the 1930s. The Congress can and should reduce, not increase, the opportunities for improper actions by utility holding companies.

In the background paper he provided to accompany Title XV of his National Energy Security Act of 1991, Senator Johnston clarified some of the thinking that went into his bill. I commend the Senator for his willingness to share his ideas, but I find it necessary to challenge some of his most basic assumptions.

In his eagerness to expand the universe of those who can enter the competitive generation market without becoming a utility holding company, the Senator seems essentially unaware of the monopoly advantages that will still be retained by the investor-owned utility companies. These advantages include a captive customer base and control over the existing generation, transmission and distribution systems as well as all the financial resources they engender.

Creating exempt wholesale generators will not in and of itself stimulate a truly competitive market. Regulated utilities are the primary customers of the would-be wholesale generators. As long as they retain both the exclusive control of the national transmission system -- and the ability to opt out of the competitive marketplace -- utilities will retain all of the advantages that their monopoly positions give them plus they will gain new opportunities for configuring themselves to extract monopoly profits from their customers.

The basic question of PUHCA revision (in my mind) revolves around the definition of a utility's obligation to serve. Is it the utility's obligation to maximize corporate profits and -- oh, by the way -- deliver electricity, or is it to serve its franchise monopoly customers in the most efficient way possible with an opportunity for a fair rate of return?

While it is true that state regulators set the rates that can be charged to these captive customers, most state commissions are designed and staffed to regulate stand-alone, vertically integrated utilities. There may be a few instances where a state commission's jurisdiction to examine the books and records of non-regulated affiliates of utilities is undisputed. However, this is not generally the case.

Some of the examples I mentioned earlier reflect the positions of various parties in ongoing cases. The Commission has not yet made any finding with respect to these cases. However, I have included them here because they help illustrate the kinds of allegations that state regulatory commissions will have to devote increasing amounts of resources to investigate, whether or not the alleged abuses actually occur.

In addition to the difficulties involved with investigating alleged abuses of multiple utility holding company affiliates in the face of disputes about access to affiliate books and records, there is another problem that is worth mentioning.

In most cases, utility regulatory commissions have clear authority to disallow unreasonable and imprudent costs incurred by a utility. However, there is a limit to the amount and frequency of disallowances that can be made before a commission must become concerned with the financial viability of the utility. If one assumes that the parent company subordinates the interest of the utility to the interests of the holding company itself, and therefore continually places the utility at risk, state commissions could easily find themselves in a "damned if you do, damned if you don't" situation.

Any legislation which removes virtually all restraints on a utility's ability to create numerous generating affiliates and partnerships -- without substantially strengthening the states' ability to address the concomitant anti-competitive abuses -- is untenable. At best, it would result in a business boom for anti-trust lawyers. At worst it could expose U.S. citizens to unconscionable rate disparities (to the extent that they could not be mitigated by local regulatory commissions) and frustrate a national goal of greater competition in the generating sector.

With all due respect to Senator Johnston, it is a fallacy to assume, as he does, that the regulatory regimes that have been enacted subsequent to PUHCA "to a large extent provide duplicative protection" and that "The Holding Company Act...has become...superfluous." Let me suggest that the opposite is true: Subsequent legislation was enacted with both the knowledge that the Holding Company Act protections against anti-competitive behaviors were in place and the assumption that they would continue to remain in place.

If it is the will of Congress to remove the protections that the Holding Company Act provides, let them clearly understand that in so doing they are creating not only a new category of competitors, but also resurrecting and energizing a group of "anti-competitors" who may seek to take unfair advantage of their monopoly power.

Who needs PUHCA? I submit that monopoly ratepayers, state regulatory agencies, and this country need it. I also submit to you that the protections of the Public Utility Holding Company Act are just as relevant today as they were in 1935. Vigorous enforcement of the Act is increasingly called for, and any changes to the Act which are intended to increase competition in the generation market should, at a minimum, prohibit utility ownership of generation in their own service areas under the guise of independent or separate companies, retain the limitations on the extent of corporate complexity and provide state regulatory bodies with undisputable access to records of transactions between a utility and its affiliates.

Thank you for your attention.

ERC
ELECTRIC RELIABILITY COALITION

THE MISSION AND ISSUES OF THE ELECTRIC RELIABILITY COALITION

The Electric Reliability Coalition (ERC)

- The ERC is a group of over 40 of America's investor-owned utilities dedicated to preserving a proven national system that has provided the United States with the world's most reliable electrical service and very low costs.

- ERC members generate the electricity for over 30 million electric customers in more that half the states and the District of Columbia. ERC members also provide electricity to hundreds of electric cooperatives and municipal distribution systems, which in turn, serve millions of additional individuals and businesses.

- The ERC has recently organized to respond to proposed Congressional legislation (S. 341) and proposals in the Administration's National Energy Strategy to deregulate America's electric utility industry. This would lead to higher costs to consumers and threaten reliability.

ERC Joins Broad-based Opposition to Deregulate Electric Utilities

- For generations, public oversight and prudent regulation has provided the framework which enabled electric utilities to reliably serve consumers while coping with recessions, fuel supply crisis, high inflation, and regulatory and legislative changes.

- However, following the same deregulatory pattern of the 1980s, some are seeking quick profits by changing the rules.

- Deregulating America's power producers would lead to: 1) Higher costs to most consumers -- while providing reduced rates to large energy consumers; 2) disrupted power supplies by ending the cooperative relationship that exists between neighboring electric utilities; and 3) environmental degradation, small IPPs (25 megawatt) are exempt from new clean air laws.

- A number of consumer groups and other important members of the electric power industry also oppose current proposals to re-write PUHCA to create a special class of favored operators: The Consumer Federation of America; Environmental Action; Public Citizen; The Energy Conservation Coalition; and others.

ERC
ELECTRIC RELIABILITY COALITION

FACT SHEET

The Dangers of Deregulating Electric Utilities

The Issue

Congressional legislation (S. 341) and parts of the Administration's National Energy Strategy propose amending the Public Utility Holding Company Act (PUHCA) to drastically restructure nation's electric power industry -- which currently produces the most reliable and among the cheapest electric power in the world.

- Advocates of utility deregulation raise two economic reasons (other than easy near-term profits) -- both of them false:
  1) FALSE -- an impending national electricity shortage exists, necessitating new incentives for independent power producers (IPPs); and,
  2) FALSE -- consumers will benefit from "competition" between IPPs and existing electric utilities.
- Overall electric capacity margins in this country are more than adequate. According to the recently issued North American Electric Reliability's report, "Electric utilities have adequate plans for the 1990-1999 period to provide reliable electric rates to their customers."
- "Competition" among neighboring utilities can reduce cooperation and coordination -- key factors in preventing brown-outs and black-outs during the last two decades.

Deregulation Would Provide Higher Profits for a Favored Few; While Causing Supply Disruptions and Higher Costs for Families and Small Businesses

- In many cases, deregulation can foster the practice of "cream skimming" among IPPs -- selling direct to major electrical users at a discount, while leaving "captive users" -- small businesses and families -- to bear potential increased costs and disruption.
- Many IPPs economic advantages are based on financial footwork, not the economies of producing power. Facts:
  - IPPs would rely on 90% (or more) leveraged financing;
  - IPPs high debts would be imputed to the utilities, resulting in higher costs to utilities and higher consumer rates;
  - Investor-owned utilities generally, have only 50% debt; and
  - The national economic cost of more highly-leveraged financing from IPPs outweighs other alleged short-term economic efficiencies in power production.

ERC
ELECTRIC RELIABILITY COALITION

FACT SHEET

A Proven and Reliable Electric Utility System

Dedication to Serve the Community

- Public utilities have a regulatory compact with consumers to provide every user in their region with electrical service. The compact is governed by state Public Utility Commissions (PUCs), which are charged with overseeing the public interest. An independent power producer (IPP) is not bound by such obligations.

- IPPs can seek to "cherry pick" a utility's large industrial customers. Such regional "cream skimming" would drive up rates for small business and residential users. In other words, the exempt few would profit at the expense of small consumers.

- IPPs and co-generators already play, and will continue to play, an appropriate role in America's energy future. Together, they currently generate 26,000 MW of power to the nation, with the expectation that this will grow to 81,000 MW by the year 2000. There is clearly no need to provide further incentives for continued growth of IPPs.

- The fundamental issue of substantially deregulating electric service is not a matter of having adequate electric generating capacity, but who will own and operate that capacity. Will it be done by unregulated, exempt companies with no legal obligation to serve the public? Or will it be done by regulated companies governed by the public interest.

Providing Reliable Electric Service at the Lowest Possible Cost

- In many cases, economic efficiency for utilities is a function of economies of scale (fuel purchases, etc.). By encouraging incremental growth of electrical capacities -- several small units being built over time -- near-term efficiencies may be achieved, but long-term large scale efficiencies and cost savings to customers are lost. In other words, the one large generating facility that wasn't built, because many smaller IPPs popped-up instead, would have produced lower cost electrical energy for customers over the long term. Electric generating plants can operate for 40 years or more.

Where is the regulatory oversight?

- There will be no enhanced regulatory oversight to cover expanded operations of IPPs. State boards that oversee public utilities have limited authority over IPPs or out-of-state sales, and no oversight of IPPs costs or profits.

ERC

ELECTRIC RELIABILITY COALITION

Consumer Voices of Opposition
To Electric Utility Deregulation

- "Senator Johnston's proposal to amend the Public Utility Holding Company Act is unnecessary, unwise, and undesirable. ...there is no demonstrable impediment to market entry by so-called "non-utility electric generators."

  -- Statement by the American Public Power Association

- "The Consumer Federation of America believes that Congress should adopt a number of new energy policies, but not the repeal of PUHCA, as contemplated by S. 341."

  -- Stephen Brobeck
  Executive Director, CFA

- "This bill [S. 341] represents an attempt by utilities to escape meaningful regulation."

  -- Ruth Caplan
  Executive Director, Environmental Action

- "Senator Johnston's bill is a wide-ranging attempt to establish a national energy strategy. Unfortunately, Title XV of this bill eliminates certain restrictions on utility holding company corporate structures and diversification that have protected utility consumers since 1935...In our view such an elimination of consumer protection is unjustified. We don't have to sacrifice consumer interests to have energy security."

  -- Billy Jack Gregg
  National Association of State Utility Consumer Advocates

- "These changes, if enacted [Title XV, Public Utility Holding Company Act], will do great damage to the environmental gains made in recent years and will make the fight for additional gains far more difficult in the future."

  -- Nancy Hirsh
  Director, Energy Conservation Coalition

- Proposals to "reform" PUHCA would increase opportunities for utilities to engage in self-dealing, monopolistic practices, and cross-subsidization schemes. This could allow utilities to circumvent state regulation and undermine state least-cost planning procedures resulting in higher rates for consumers."

  -- Ken Bosson
  Public Citizen

ERC
ELECTRIC RELIABILITY COALITION
1050 17th Street, N.W., Suite 550
Washington, D.C. 20036

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March 14, 1991

Contacts:
Tom Gibson (ERC)
(202) 638-2121
Rick White (CP&L)
(919) 546-7908
Graham Painter (HL&P)
(202) 467-5040

DEREGULATION OF ELECTRIC UTILITIES: ANTI-CONSUMER AND "A LEAP INTO THE DARK"

Washington, D.C. -- Leaders from America's investor-owned electric utilities today harshly criticized Administration and Congressional proposals to deregulate electric utilities, citing patterns of abuses, increased consumer costs, and reduced service that mirror the deregulatory disasters of the 1980s -- S&Ls, airlines, health care, and telephone service.

Sherwood Smith, Chairman of Carolina Power & Light and Don Jordan, Chairman of Houston Lighting & Power, joined other consumer advocates and energy industry experts in opposing amendments to Title XV, of the Public Utility Holding Company Act (PUHCA), in S. 341. The two spoke on behalf of the Electric Reliability Coalition (ERC), a group of over 40 investor-owned utilities that together provide electric power to over 75 million Americans.

According to Smith, "Amending PUHCA is a deregulatory experiment that is a leap into the dark, that is particularly dangerous for an industry that is capital intensive, complex, and where there is no crisis." Smith cited the information provided by the White House Domestic

(MORE)

Policy Council and the North American Reliability Council that electric capacity through 1999 is adequate, and that reserve margins appear to be growing.

Don Jordan cited examples of current abuses that earlier moves to deregulate electric utilities have caused. Jordan said, "Loopholes in PURPA have led to abuses such as 'simultaneous buy/sell' schemes and have added $190 million a year to the electric bills of Houston consumers," said Jordan. Jordan also cited examples of how unregulated independent power producers (IPPs), with no obligation to serve the community, can simply shut down in the face of difficulty. One example involved the reaction of unregulated power suppliers to Hurricane Gilbert in 1988.

In the future, Jordan fears that IPPs will "cherry pick" large industrial electric customers from the electric grid, leaving smaller consumers -- small commercial and residential users -- to shoulder the financial burden of the entire system, by paying higher rates.

Jordan said, "The same groups that urged change in the form of PURPA, and have profited at the electric consumer's expense, now seek the creation of a new class of unregulated power suppliers. S.341 endorses the creation of a new class of power producers reliant on the highly leveraged financing schemes and complex corporate structures that the 1935 act prohibited."

# # #

BEFORE THE SENATE ENERGY AND COMMERCE COMMITTEE

March 14, 1991

Testimony of Arthur Breipohl, Sc.D.

My name is Arthur Breipohl. I am a Professor of Electrical Engineering at the University of Oklahoma, where I have been a member of the faculty for over 6 years. I have also been on the electrical engineering faculty at Oklahoma State University and the University of Kansas, where I was Department Chairman for nine years. A copy of my curriculum vitae is attached.

My teaching and research activities are focussed on the technical aspects of electric utility systems planning, and I have been particularly interested in reliability ever since my employment at Sandia Corporation beginning in 1957. Based on my study of these complex and interdependent electrical supply systems, I am very concerned about the effects on reliability of legislation, such as Title XV of the National Energy Security Act, that would increase the numbers of non-utility owned and operated wholesale electric generation facilities connected to local and regional electric grids.

Since the massive Northeast blackout of 1965, we have evolved a national and regional system for controlling electrical generation and transmission. This system is characterized by inter-utility interconnection and cooperation. The system ensures very high levels of reliability under both normal and emergency conditions.

Regardless of what we call the new third-party facilities -- Exempt Wholesale Generators (EWG), independent power producers, or something else -- these units could be extremely difficult to integrate into the present system, which was designed for cooperating regulated utilities. Among other problems, the addition of third-party generators onto utility systems can result in increased flows of power into adjacent utility systems. As competition and compensation for power flows become more prevalent, cooperation between interconnected utilities will diminish. This disintegration of cooperative inter-utility operating arrancements will leave the control system, which was designed for a cooperative environment, vulnerable to potentially catastrophic failures, and electrical outages to customers may result. The problem will be even more severe if utilities lose control of power being transmitted across their systems to other utilities.

I believe the reliability impacts of encouraging competition among utilities and between utilities and new third-party generators should be carefully examined before any legislation, incremental or otherwise, is considered. Necessary changes in the control system would have to be studied, developed and implemented before the industry's structure could safely be changed. The required change may be too costly or it may require an unacceptable transfer of system control to a national government agency. (In England, a national transmission network is responsible for control of deregulated generators.)

My testimony explains that the physical laws which uniquely determine electric power flows, together with cooperation between regulated utilities, have led to the present system of control. This system was successfully designed to prevent outages that can destroy reliability of service. Then I review one historic crisis to illustrate the importance of reliability to electricity customers. A second, more contemporary crisis is reviewed to illustrate the reliability of the present cooperative electrical supply system. Finally, I suggest the kind of crisis that we may face in the future if unregulated entry into the generation function is encouraged. I conclude by explaining why, if there is to be a change in the philosophy on which the present electrical supply system was designed, as reflected in a change in the industry's structure, we must consider the necessary redesign of the supply system and its control. Only in this way can we intelligently weigh the costs of these changes against the asserted benefits of changing the industry's structure.

The control of electric power flow is subject to three immutable physical "laws." The first "law" is that electrical energy cannot effectively be stored. This means that, at each instant on an electrical system, supply of electric energy must equal demand. The other two "laws" are Kirchoff's "laws". Kirchoff's second or voltage "law" dictates that electric current will often, and unpredictably, flow in actual paths that are quite different than the contract paths specified in a power sale and/or transmission contract. These three laws are taught to all electrical engineering students, and are emphasized in many recent studies, e.g. [1], [2], [3], of the effect of deregulation on the supply of electrical power. These three "physical laws" must be considered in the design of any control system.

The present system by which we control the nation's electrical production, transmission and distribution system was designed to depend heavily on a spirit of close cooperation among utilities. The system operates under either of two states, depending upon the prevailing conditions: normal and emergency. In the normal state, supply equals demand without corrective action by the control system. In this state, the control system has the primary purpose of minimizing cost; that is, economics are dominant. In the emergency state, equipment failure or unexpected load changes have caused a state such that many customers face the imminent loss of electricity. The control system is designed to ignore economics and to make the needed adjustments to maintain the integrity of the power supply system and preserve electrical service to as many customers as possible. In an emergency, reliability is the dominant consideration.

The importance of reliability, as well as how much progress we've made in preventing interruptions of service over the last 25 years, can best be appreciated by comparing two crises. The first is the Northeast blackout of November 9th and 10th, 1965, during which a blanket of darkness covered much (28 operating electric utilities were affected) of the Northeast of the United

States and parts of Canada [4]. While there had been previous blackouts (e.g. in June of 1950 a widespread outage within the Bonneville Power Administration system) and there have been subsequent blackouts (e.g. in July of 1977 in New York City), this massive power failure provides the most dramatic example of the effects of system unreliability.

It is important to understand how the blackout occurred. At 5:16 p.m. on November 9, 1965, a protective relay "tripped", as it was designed to do, in order to disconnect an overloaded line that carried power from Niagara to Toronto. This flow of power was then, according to Kirchoff's "laws", shifted to four alternate paths. The additional flow overloaded the remaining lines, and as a result these lines were also disconnected by their protective systems. The power then found a new path, flowing from Niagara to Western New York, and this sudden increase in power flow caused the transmission system in Western New York State to break down, i.e. transmission lines were overloaded and subsequently disconnected by normally operating overload protective systems. Meanwhile, the generators (at the Beck plant and PASNY - Niagara), because their load was removed, increased rotational speed and thus became "out-of-step" (i.e. out of synchronism) with the remainder of the interconnected power system. This "out-of-step" condition caused an ensuing chain reaction of power failure. More generators and transmission lines were automatically disconnected. The physical control system was at this point operating according to design.

This chain reaction resulted in isolation of areas that had large excesses of generation and areas that had large deficiencies of generation. Of course the areas with deficiencies suffered blackouts while the areas with excesses had to shut-down some of their generation.

To quote one observer's description of the blackout [4]:

> It was perhaps providential that the regional power failure occurred during relatively mild weather, with a clear sky, and under the light of a full moon - almost the sole source of auxiliary illumination for 30 million people - rather than during blizzard conditions and freezing temperatures.
>
> The helplessness of people trapped in underground transit systems and in buildings, plus the intolerable situation of muted air raid sirens, nonfunctional traffic signals, and unlit stairways and emergency exits, suddenly revealed a massive blind spot in our thinking and planning. Except for some hospitals, and isolated instances where design foresight paid off for commercial or industrial buildings, most of New York City was caught entirely without any auxiliary power sources.

Subsequent economic studies have quantified the staggering cost of this "great blackout."

The traumatic effect of the Northeast blackout on the public, and on policy makers, caused the electric utilities to take a number of steps to minimize the chances of a recurrence. Two of these steps are particularly significant. A cooperative not-for-profit federation of electric utilities called the North American Electric Reliability Council (NERC) was established on June 1, 1968. [5] As NERC explains its mission: "NERC helps electric utilities work together to prevent blackouts" [5].

The second significant step was to increase the strength of the transmission interconnections between utilities and to reinforce the principle that, while each utility retains the responsibility to supply its own load, each utility also has the obligation to help its cooperating interconnected utilities in emergency conditions. The obligation to help cooperating neighbors was manifested in a control system that automatically, when sensing lower frequency, requested power to be transmitted in from neighboring utilities over the strengthened transmission interconnections. Each utility was required to keep a certain amount of generation capability ready but unused. This generation is often called "spinning reserve". The results of the steady evolution of the control system, and the importance of cooperation during emergencies, is well illustrated by a more recent crisis that occurred on the Oklahoma Gas and Electric Company (OG&E) system.

On August 25, 1977 all three steam units at OG&E's Seminole station failed within about two minutes [6]. At that time they had been supplying 1440 MW, which was approximately 43% of the system load. (The three generating units at Seminole are gas fired and are supplied by a 16-inch fuel-gas line. A mechanical device, which is called a pig, is used to remove condensed liquid from the fuel line, and "pigging" was scheduled for the day in question. Although pigging had been accomplished successfully many times and although proper procedures were supposedly followed, the arrival of the pig at Seminole, which occurred at about 4:30 p.m., resulted in the liquid - primarily salt water - extinguishing the flames in the boilers of Seminole unit 3; then the boilers of units 1 and 2 suffered similar fates.)

The emergency control system operated and assistance from neighboring utilities brought power into OG&E's system. For example, one of the transmission lines connecting OG&E with its Northern neighbor, Kansas Gas and Electric Company (KG&E) immediately changed from 20 MW import to 250 MW import. However, this line was overloaded to the extent that its protective system automatically "tripped" and opened the line. Thanks to the strong "interties" (i.e. numerous transmission lines interconnecting OG&E with KG&E and other utilities), other transmission lines carried a total of more than 1200 MW into OG&E's system from its neighboring cooperative utilities. (We don't know exactly how much was imported because the system dispatcher's meter which shows net imported power was off-scale, i.e. above 1200 MW).

Non-automatic remedial action was immediately started. This action included many internal corrective actions which are ignored in this account. For our purposes, it is significant that adjacent systems were requested to arrange for any power that they would make available. Additional power was supplied by the cooperating utilities and a 300 MW sale by OG&E to Middle South Utilities which had been in progress was terminated.

Approximately five and one-half hours after the pig arrived at Seminole, the interconnected system returned to normal operation. Reliability had been maintained by the automatic control system, and by subsequent corrective action on the part of OG&E personnel and its cooperating neighbors.

Two important features of the interconnected power system enabled it to respond to this crisis and avert a blackout: First, OG&E was (and is) a member of the Southwest Power Pool (SPP) which in turn is a part of NERC. As a part of the membership requirements each utility (more precisely each control area) is required to have spinning reserve, i.e. on-line generating capacity which exceeds the required generation by a set amount. This on-line (sometimes called spinning or ready) reserve carried by OG&E and its neighbors enabled OG&E to withstand this emergency. Second, the bulk power transmission system had sufficient capacity to carry the vastly increased load associated with the necessary corrective action dictated by the automatic control system.

Would the control system function as effectively if there were a large number of non-utility generating units on the affected system or on other systems in the affected power pool? I believe that it would no function adequately without substantial change in methods of operation and control.

The control system and the accompanying reserves of both generation and transmission have been designed under the assumption that there would be cooperation among suppliers. If this cooperation is replaced by competition, then the control system will have to be fundamentally redesigned. To illustrate this point, consider the way that the current system deals with "loop flows," a common phenomenon on interconnected power systems. Because electricity seeks out sometimes unpredictable paths, power that is intended to flow from generators into one utility's system actually may flow into and through another utility's lines, consuming some of the latter system's transmission capacity. Under the present system, the latter utility generally would not object to these flows because it receives reciprocal benefits from the first utility.

This situation would be quite different under some future scenarios involving EWG power, particularly if utilities are required to, or elect to, wheel EWG power. Suppose that an EWG sells power to a buyer using a contract path through utility X's transmission lines. However, interconnected utility Y determines that most of this power actually flows through its lines. In order to preclude this uncompensated flow, Y installs a controller in the form of a phase-shifter or perhaps a DC tie. (This would be somewhat like installing a circuit breaker that would trip if undesired flows came into the newly-protected system.) A large part of the flow is thus shifted to utility Z, which is also uncompensated, and Z then also installs a power-flow controller, and so on. Power wars would have begun, with each system limiting its interconnections with other systems in an effort to protect itself.

While this would be unfortunate during normal operation, it could be disastrous during emergencies. In an emergency, the present control system senses a frequency decrease and requests a dramatic change in flow over one of the controlled lines. If, however, a local controller has been installed on the line, the necessary flow cannot occur, the flow would occur elsewhere, and a series of "cascading outages" could lead to a major blackout.

I do not mean to say that it would not be technically possible to create a new control system that could accommodate EWGs. But to do so would require major operational and technical changes in the present system, under which control and responsibility are assigned to "control areas", and the control areas cooperate. One scenario would be establishment of federal control of a national transmission grid that would be responsible for system reliability and for supervision of all generation, including EWG facilities. However, any redesign of the power system control to accommodate competition, will have to address some tough questions, i.e., who is responsible for the physical control as well as the legal obligation to serve electricity customers? In my opinion, these tough questions should be answered before Congress takes any steps, even incremental ones, toward deregulation.

In conclusion, the traumatic effects of unreliability of the electrical supply system were demonstrated by the great Northeast Blackout. Out of this experience emerged a complex cooperative electrical supply system which operates very well in emergency conditions. The proposed transition from cooperation to competition among electricity suppliers portends serious reliability problems. In my opinion, the present remarkably effective control system could not remain effective in a competitive environment.

It is possible that, with present increased communication and computation capabilities, an effective control for the electrical supply system, which operates in emergency as well as normal conditions, could be designed to counteract the effects of competition at the generating level. However, considerable study should be given to the engineering details of any such new system, and the necessary changes be implemented before the floodgates of change in the electricity industry's structure are opened by legislation to promote EWGs. It might be logical from the point of view of economics to move incrementally toward a competitive power supply system. But it certainly is not logical from the point of view of reliability to do so now. We need to carefully reevaluate the control of the power supply system before attempting to operate it with competitive suppliers.

> "Cheshire Puss .... Would you tell me, please, which way I ought to go from here?
>
> "That depends a good deal on where you want to get to," said the Cat.

from Lewis Carroll's Alice's Adventures in Wonderland.

Do we want to get to a less reliable electrical supply system?

References

[1] U.S. Congress, Office of Technology Assessment, Electric Power Wheeling and Dealing: Technological Considerations for Increasing Competition, OTA-E-409 (Washington, DC: U.S. Government Printing Office, May 1989).

[2] North American Electric Reliability Council, Electricity Transfers and Reliability, Oct. 1989.

[3] Federal Energy Regulatory Commission, The Transmission Task Force's Report to the Commission "Electricity Transmission: Realities, Theory and Policy Alternatives", Oct. 1989.

[4] Friedlander, G.D., "The Northeast Power Failure - a Blanket of Darkness", IEEE Spectrum, Feb. 1966.

[5] North American Electric Reliability Council, Power in Balance, Aug. 1989.

[6] Sebesta, D., "Responsive Ties Avert System Breakup", Electrical World, April 1, 1978.

Testimony of Dr. Kenneth Nowotny

Associate Professor of Economics and
Associate Director of the Center for Public Utilities
New Mexico State University
Before the Senate Committee on Energy and Natural Resources

On

Title XV of the National Energy Security Act of 1991:
The Public Utility Holding Company Reform Act

I. Summary of Comments

This testimony looks at the conditions surrounding and the theory behind the proposed legislation. There are two basic issues which need consideration.

(1) Is the assessment of existing power supply and power markets accurate?

(2) Are the benefits touted actually to be available in an Exempt Wholesale Generator (EWG) environment?

The legislation incorrectly assumes that U.S. electric utilities are no longer natural monopolies. The fact is that electric utilities are natural monopolies and are likely to continue to be so long into the future. This natural monopoly status derives from conditions of cost due to horizontal and vertical integration. These conditions of cost derive as much from the fact that electric utilities provide a bundle of products to the public, for example, reliability as well as current at dependable frequency, as from firm level economies of scale.

The economies of vertical coordination in a technological situation wherein simultaneous concatenation of production and consumption is required, if the system is to function at all, cannot be overstated. Electric utilities have integrated vertically and horizontally to conserve on transactions costs and to internalize potential third party costs. In a setting wherein decisions involve very long-lived investments, uncertainty concerning operating configurations and costs twenty years hence demand that the utility avoid being vulnerable to the vagaries of contracting and the opportunistic behavior of other firms.

All that is required for the existence of natural monopoly is a showing that any bundle of outputs can be produced at a lower total cost than if that same bundle were produced by more than one specialty firm. If EWG's are to put 60 hertz current into a line, who shall provide the reliability portion of the bundle? As is likely, it will be the utility, and as a result of inappropriate siting, short-sighted planning, added frequency of contracting, and the inevitable additional market uncertainties, the cost of the bundle will certainly be higher than if offered by a utility in isolation.

Even if this were not true, the fact is that the evidence as to whether or not electric utilities continue to possess economies of scale, and thus are most certainly natural monopolies, is highly conflicting. One can find as many econometricians who will show the existence of scale economies as those who will show the reverse. But even if it were true that very large utilities have exhausted scale economies (and I believe that is not the case), it would not matter.

Economics can demonstrate the situation of weak natural monopoly wherein natural monopoly will continue to exist well beyond the point of scale exhaustion. In such a condition, it becomes even more imperative that regulators absolutely prevent entry into the monopolist's market, and of course, regulate the price charged.

The only basis upon which the EWG proposition can be defended is on the grounds that, somehow, competition will flower in the industry and drive costs to a minimum for the production of 60 hertz current alone. But this is purely hypothetical. The greater likelihood is that we will see an industry dominated by a tight oligopoly, riddled with long-term, uncontestable take-and-pay contracts, the erection of insurmountable entry barriers, and negotiations conducted by bilateral monopoly. There is no *a priori* reason to expect that the public's interest will be served.

This legislation will deprive the public of the cost savings associated with price regulated natural monopoly in exchange for an unregulated tight oligopoly and the associated anti-competitive results. And to what end ? Table 1, below indicates that the real price of electricity, between 1970 and 1989 increased only 28 percent, and has decreased since 1985. In the same period, the price of natural gas increased 238 percent, crude oil 122 percent and coal by 55 percent.

Year	Electricity (Cts/kwh)	Natural Gas ($/MCF)	Crude Oil ($/BBL)	Coal ($/sh.t.)
1970	3.98	0.40	8.10	15.40
1972	4.00	0.41	7.70	18.02
1977	5.08	1.17	17.77	30.27
1980	5.08	1.86	32.75	33.27
1985	5.81	2.26	26.75	31.14
1989	5.10	1.35	17.96	23.86

Table 1:

Real Price of Energy
(1982 $ - GNP Deflator)

Source: U.S. Department of Energy
Annual Energy Review: 1989
U.S. GPO, Washington, D.C.
May, 1990

Frankly, I would have to say that the public has been getting a bargain from the nation's electric utilities. What is it, indeed, that is broken, that is so in need of being fixed ?

II. The Multi-Product Natural Monopoly

A. Definition

Since the economic rationale for utility regulation is intertwined with technical aspects of cost, it is necessary to define precisely the term natural monopoly. Essentially, if a single firm can produce a desired level of output at lower total cost than any output combination of more than one firm, then a natural monopoly is said to exist. William Baumol has formalized this point by introducing the concept of subadditivity.[1] Baumol, Panzar, and Willig, in remarking on the nature of subadditivity add:

> [subadditivity] surely, is what anyone has in mind, at least implicitly, when speaking of a monopoly being "natural," and that is what economists were undoubtedly groping for when they (as it turns out, mistakenly) identified natural monopoly with economies of scale.[2]

A single-product firm exhibits economies of scale if its long-run average cost function is decreasing. While it is true that a production process which exhibits economies of scale is subadditive at that output level, a production process may also be subadditive and exhibit increasing average cost. A formal proof of this statement is given by Berg and Tschirhart.[3]

But there is another more important case of natural monopoly and an even more crucial reason to avert our eyes from the focus of scale economies: the multi-product natural monopoly. In all likelihood, this case is more descriptive of the nature of the electric utility industry. If this is so, then economies of scale have no relevance to the discussion whatsoever.

B. Electric Utilities as Multi-Product Natural Monopolies

Electric utilities supply a large variety of services

1/ Baumol, William J. "On the Proper Cost Tests for Natural Monopoly in a Multiproduct Industry." American Economic Review. 67 (1977): 808-822.

2/ Baumol, William J., John C. Panzar, and Robert Willig. Contestable Markets and the Theory of Industry Structure. New York: Harcourt, Brace, and Jovanovich, Inc., 1982.

3/ Berg, Sanford, and John Tschirhart. Natural Monopoly Regulation: Principles and Practice. Cambridge, G.B.: Cambridge University Press, 1988, forthcoming.

including varying proportions of generation, transmission and distribution of various voltages, reliability, and load stability. With multiple outputs, economies of scale are neither necessary nor sufficient for natural monopoly.[4/] On the contrary, a firm may experience increasing unit costs for each output but if lower total costs can be achieved by a single firm coordinating the production of all industry services, a natural monopoly exists.

Evidence on scale economies may ignore economies of scope and provide a distorted image of natural monopoly in electric power. Economies of scope are said to exist if it is less costly to produce a given output bundle in a single multi-product firm than to produce the same level of each of the distinct outputs in the bundle in more than one specialty firm.

Research on the more general economies of scope is limited but preliminary results indicate that cost increases may result from vertical deintegration. Frank Gollop and Stephen Karlson as well as Alan Finder estimate electric power cost functions which separate output into wholesale, industrial, commercial, and residential services.[5/] Both studies find strong evidence of

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[4/] Sharkey, William. The Theory of Natural Monopoly. Cambridge: Cambridge University Press, 1982.

[5/] Gollup, Frank M. and Stephen H. Karlson. "Returns to Scale in Multiproduct Firms: An Application to the Electric Power Industry." Wague State University working paper, 1980, and Finder, Alan E. "Empirical Tests of Cost Subadditivity in the Investor Owned Electric Utility Industry," presented at ASSA meetings, San Francisco, 1984.

natural monopoly for even the largest of Investor Owned Utilities (IOU's).

For a multi-product firm to be a natural monopoly there must be some type of economies of joint production. It is this idea of "jointness" that distinguishes multi-product from single-product natural monopoly.

The factors that may contribute to this are, e.g., specialization and indivisibilities in inputs. That is, there are economies of coordinating production activities within a single firm. Berg and Tschirhart add that:

> Here, we would expect that two (or more) outputs could share an accounting, marketing, or other administrative department and incur less cost than if each output utilize a separate department. Or, there may be some externality that becomes internalized when two (or more) outputs are brought into the same production process. Producing beef and leather hides is one classic example of shared inputs... daytime and nighttime electricity [is] another example.[6/]

The electric industry is a good example of economies of coordination. As noted above, electric utilities supply a large variety of services. For a power system to be in equilibrium the amount of the power demanded must equal the amount of the power generated. Failure to maintain this equation at any instant can result in system failure.

[6/] Berg, Sanford and John Tschirhart. Natural Monopoly Regulation: Principles and Practice. Cambridge, G.B.: Cambridge University Press, 1988.

C. Natural Monopoly and the Externality Problem

Moreover, this necessity for continuous vertical coordination can be considered as creating a vast externality problem. The externality centers around the fact that decisions made at any stage can dramatically affect system viability and reliability.

An externality exists if a firm engages in an activity without incurring the full cost or enjoying the full benefits of its consequences.

Examples of negative externalities are air and water pollution while positive externalities may involve the standardization of equipment and materials, the coordination of production activities, and sharing of facilities. If there exist institutional arrangements which force a firm to bear the full costs imposed on other firms or which allow the firm to realize the full benefits it renders to others then we say that the externality has been internalized.

In current practice the externality is internalized because the single firm bears all of the consequences of each activity. Vertically deintegrating the generation, transmission, and distribution functions among a multiplicity of firms, while maintaining current levels of system reliability and stability, at best could only happen with an enormous increase in cost and at worst could be technologically impossible.

Regulatory schemes involving vertical deintegration would increase the number of firms owning the components of the system and increase the diversity of interests among these firms. Thus, internalization is no longer guaranteed. At worst, vertical deintegration precludes internalization; at best, it significantly increases the transactions costs associated with coordination.

Probably the most crucial potential externality to which the EWG environment is likely to expose the electric industry is that of loop flow. As between any two nodes on a transmission grid, assuming they are the only two interconnected positions, power can flow smoothly, or relatively so, so long as generation reductions at the receiving node match the increases at the sending node and there is no, ceteris paribus, change in electricity demand.

Two contracting parties can expect that the contracted exchange in power will occur at the rate required by demand conditions. In such a case, any difficulties occurring as to transmission facilities can be handled, i.e., negotiated, between the contracting parties. Potential externalities are internalized by the contract. But the assumptions regarding such a contract are altogether too simple in today's complex system of interconnections.

Exchanges of power do not occur simply between a receiving node and a sending node, uniquely connected together. Otherwise the electric grid system in the U.S. would not be referred to as a grid. Contiguous utility systems are connected together in relationships, with few exceptions, which involve greater than paired transactions. Thus for any transaction between any two parties, there will virtually always be an involved third party or parties.

Unfortunately, as one professor of electrical engineering has observed, electricity will follow the laws of physics, not the law of the land.[7/] Ohm's Law indicates that electricity will move along the path of least resistance (impedance). The result of this fact is that one observes power flowing over transmission lines which are no part of a transaction. This is an externality as discussed above.

The third party may have to rearrange its own interchanges of electricity, and in fact, may have to build additional transmission capacity in order to protect itself from contractual flows of power to which it is not a party, nor derives any benefit. This loop flow problem can be substantial.

A FERC publication, Power Pooling in the Western Region, made the following observations,

> Recent loop flows in the 300-600 MW range measured between the RMPP [Rocky Mountain Power Pool] area and the Arizona-New Mexico systems have been common. The increasing clockwise loop flows are now and will continue to adversely affect the transmission system in the southern part of the RMPP area and the ability to export economy coal-fired energy to replace southwest oil-fired energy.
>
> No practical solution to this problem exists.... However, as the growth of RMPP Area coal-fired generation increases to serve firm north-west loads, the clockwise loop flow

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[7/] Kersting, William H. "Does the Physical Infrastructure Exist?" Remarks for Deregulation of Electric Generation: Is It Time? A Conference on the Center for Public Utilities, New Mexico State University, held at Santa Fe, New Mexico, September, 1986.

> problem will continue to increase.
>
> Possible solutions include the opening of tie lines and the installation of phase shifting transformers. However, none of these solutions appears appropriate at present from an interconnected standpoint.[8]

"Fixing" the problem of loop flow is of course an engineering possibility. But such a fix will involve the expenditure of millions of dollars on such equipment as high voltage DC interties, equipment which will be transaction specific. Aside from the fact that such sunk costs involve virtually impenetrable barriers to entry into a market, they also involve additional substantial sums of money which must be added to the cost of the changes this legislation seeks to implement.

Obviously, that fact that EWG contracts would be voluntary does not mitigate the loop-flow problem. The RMPP grid is a voluntary system of interconnections. Recently, a utility receiving power from Palo Verde Nuclear Generating System (PVNGS) built a new transmission line over which to receive power from PVNGS. An interconnected utility disputed the power flows asserting that it would have to invest money in transmission protection because of the nature of the loop flow. The interconnected utility, in arbitration, was shown to be correct. And all of this was voluntary. Does anyone envision that an EWG environment will simplify this problem?

8/ Western Regional Task Force, Federal Energy Regulatory Commission, Office of Electric Power Regulation, Power Pooling in the Western Region, Washington, D.C.: Superintendent of Documents, U.S. G.P.O., February, 1981: p. 89.

In any event, it simply is not clear that incremental modifications in legislation will not lead to mandatory transmission access. Moreover, one might speculate that in a vastly expanded EWG environment, an extension of the doctrine announced in the Otter Tail Power case,[9] against monopoly leveraging, could lead to court ordered mandatory wheeling.

D. Economies in Horizontal and Vertical Integration

At the present time, however, there are cost savings achieved through vertical and horizontal integration. Vertical coordination between generation, transmission, and distribution may also result in cost savings at the planning stage -- through the timing of needed investments -- and during operation -- by the scheduling of maintenance and the use of energy interchange to meet a given demand with less capacity connected to the load.

In addition, horizontal integration at the regional level may result in cost savings owing to increased load diversity and a smaller fraction of spinning reserves required for a given level of reliability. Power pools are good examples of this type of coordination with the biggest single benefit of pooling involving the cost savings in reserve generating capacity. As Gegax and Tschirhart point out:

Utilities maintain generating capacity in operating reserve status to meet unexpected increases in demand, equipment failures, and maintenance. The level of reserves needed depends primarily on the size of on-line generating units and the loss-of-load probability the utility wants to achieve. An isolated utility may determine that a particular level of reserves is needed to meet the risk of excess demand; but this level can be reduced through coordination, since the risks confronted by two or more coordinated utilities are less than the sum of risks confronted by the utilities in isolation.[10]

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[9] Otter Tail Power v. U.S., 410 U.S. 366 (1973).

Many large utilities in the U.S., however, Gegax and Tschirhart point out, avoid power pooling precisely because they can achieve the economies of horizontal integration without the necessity of incurring contracting and coordination costs with neighboring utilities.

III. Natural Monopoly and Economies of Scale

A. Strong and Weak Natural Monopoly Defined

It is necessary to distinguish between instances of decreasing average cost and instances in which costs are subadditive but average cost is increasing. Since the former is a stronger condition, a firm which exhibits decreasing average cost will be referred to as a strong natural monopoly. The latter will be referred to as a weak natural monopoly.

In the case of the weak natural monopolist, it is possible

10/ Gegax, Douglas and John Tschirhart. "An Analysis of Interfirm Cooperation: Theory and Evidence form Electric Power Pools." Southern Economic Journal. 50 (1984): 1077-1097.

that a firm may enter the monopolist's market and take a portion of the former monopolist's sales. But because costs are subadditive, a multiplicity of firms producing the output would be less desirable than a single firm producing that output. The policy conclusion is that the regulator must absolutely prevent entry into the weak natural monopolist's market, and, of course, regulate price.

In the strong natural monopoly situation, however, if we require that price equal incremental cost, the firm is not viable, because incremental cost will be less than average cost. It is necessary to allow the strong natural monopoly to recover at least the average cost of production in the price of the product. But this may be done in ways which are efficient, i.e., send the economically "correct" signal to consumers, or ways which are inefficient.

B. The Economics of Efficient Prices

One possible solution to the natural monopoly dilemma is found in price discrimination. Baumol and Bradford considered the case of the strong natural monopolist.[11] Their work shows how the "Ramsey Rule" is derived and some of its implications for allocative efficiency. The Ramsey Rule maximizes wellbeing subject to a revenue constraint by choosing the set of prices such that distortions in output are minimized.

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[11] Baumol, William J. and D.P. Bradford. "Optimal Departures from Marginal Cost Pricing." American Economic Review. 60 (1970): 265-283.

Here, the second-best solution is one in which those consumers who have the fewest alternatives receive the greatest mark-up over marginal cost. Consumers which have the greatest number of viable alternatives will receive the smallest mark-up over marginal cost. Difference in price depend, then, on differences in demand elasticities, rather than differences in cost. The Ramsey Rule is an example of price-discrimination.

The determination of efficient prices may be affected by the growth of "firms which employ greatly differing technologies to provide services which can be viewed as imperfect substitutes for one another."[12] This type of competition is referred to as intermodal competition.

Ronald Braeutigam has set up a model in which there is a regulated strong natural monopolist and firms from other competitive industries offering different modes of service.[13] Braeutigam gives railroads offering freight transportation services as being an example of the strong natural monopolist and others such as motor carriers and water carriers as different modes offering services that are close substitutes for rail transport.

With the addition of other modes of service, the demand elasticities for each customer class facing the regulated firm will be affected. From the perspective of the regulated firm,

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[12] Braeutigam, Ronald R.. "Optimal Pricing with Intermodal Competition." American Economic Review. 69 (1979): 38-49.

[13] Ibid.

Ramsey prices are now efficient only if such a pricing rule is also being adhered to by firms in the other industries as well.

If the competitive nature within these other industries drives price down to marginal cost, then the set of Ramsey prices charged by the regulated firm is no longer desirable.

One implication of Braeutigam's result is that in order to ensure allocative efficiency the regulatory body would have to regulate all of the rival firms as well. Efficient pricing by the regulated firm would require that the rivals also charge Ramsey prices. This might require that the regulatory body restrict entry into the other industries as well. Ed Zajac has pointed out one circumstance of vulnerability which is possible for the efficiently pricing monopolist.[14/]

Zajac proves that no matter how the required revenue is apportioned among customer classes, it would always be that some classes are contributing in excess of their respective stand-alone cost. They would have an incentive to purchase the service from a rival firm. Ramsey prices would be unsustainable.

Such a firm must have its market protected in order to benefit from cost subadditivity, even when charging the most economically efficient prices.

The point is, simply, that the readiness of firms to enter into an industry does mean that the entry is either efficient, or

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[14/] Zajac, E. E. Fairness or Efficiency: An Introduction to Public Utility Pricing. Cambridge, MA: Ballinger Pub. Co., 1978.

cost justified in any way.

IV. The Exhaustion of Scale Economies

Questions have arisen regarding the natural monopoly status of electricity generation due to the exhaustion of scale economies. Economies of scale are exhausted if production costs rise as fast or faster than output. The absence of scale economies could (but do not) indicate the viability of competitive firms.

Several studies have analyzed scale economies for the IOU. In the most widely cited of these studies, Christensen and Greene conclude on the basis of 1970 data that scale economies in generation are exhausted by the firm with about 4000 megawatts (MW) of capacity.[15] Please note the differentiation between firm-level and plant-level economies of scale. If the former are important, the latter may take on no importance whatsoever. Taking this estimate as representative, it is interesting to observe the actual firm size of IOUs.

Of the 180 IOUs possessing their own generating capacity in 1989, about fifty-five percent had generating capacity of 2000 MW or less, well within the estimated range of declining average costs. Only twenty percent possessed over 6000 MW of capacity, where Christensen and Green estimate, average costs are constant to slightly rising. Thus, using this estimate, one would be forced to conclude that free entry would decrease the number of IOU's.

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[15] Christensen, L.R. and William H. Greene. "Economies of Scale in U.S. Electric Power Generation." *Journal of Political Economy*. 84 (Aug., 1976): 655-676. It should be emphasized that the economies of scale numbers reported here are for an entire *firm*. Individual plant level economies of scale are exhausted at significantly lower levels.

Simple estimation of scale economies at the generation level may produce biased estimates by the failure to account for possible input price distortions. In two attempts to account for price distortions, Atkinson and Halvorsen estimated that scale economies were not exhausted at the firm-level by firms possessing as much as 12,000 MW of capacity and Nelson and Wohar find no evidence of declining scale economies as average firm size increased between 1950 and 1978.[16]

One cannot adequately counter a citation on the disappearance of economies of scale with an alternative citation on its continued existence, however. Such a practice involves the assertion that "our econometricians are better than your econometricians." In a forum such as this, such claims are inappropriate and unuseful. However, on plant level economies in generation, Joskow and Schmalansee have concluded

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[16] Atkinson, Scott E and Robert Halvorsen. "Parametric Efficiency Tests: Economies of Scale, and Input Demand in U.S. Electric Power Generation." International Economic Review. 24:3 (Oct., 1984): 647-662. and Nelson, Randy A. and Mark E. Wohar. "Regulation, Scale Economies, and Productivity in Steam Electric Generation." International Economic Review. 24:1 (Feb., 1983):57-79.

> On average the industry's existing capital stock for generation thus does not appear to embody full exploitation of available plant-level economies of scale ... In any case, over time, as old plants are replaced by efficient new ones, we can expect a substantial increase in plant-level concentration in bulk power markets. Competitive problems associated with deregulation may thus worsen over time as the generation capital stock turns over.[17]

Joskow and Rose cited evidence that, on subcritical units, a doubling of capacity from 350 to 700 megawatts results in a 20 percent drop in per-megawatt costs of construction.[18] At the same time, average plant availability declines from about (interpolating) 76 percent to about 67.6 percent, an average availability decline of about (8 to 9 points or) 11 percent.[19]

In the primary coal technology, then, scale economies in construction are not dominated by availability problems on plants at least up to 700 megawatts. Now 700 megawatts, or even 500 megawatts, are not small plants. "Mom and Pop", ready-to-enter-any-market operations are not likely to even begin to take advantage of the scale economies available for base load technology. The FERC's OEP Staff report indicated that average non-utility capacity was approximately 41 MW.[20]

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[17] Joskow, Paul L. and Richard Schmalansee. Markets for Power: An Analysis of Electric Utility Deregulation. Cambridge, MA: MIT Press, 1983: p.54. (Emphasis added.)

[18] Ibid., p. 19.

[19] Ibid., p.23.

[20] OEP Staff Report, Op.Cit., p.28: 17313 MW/ 380 facilities = 45.6 MW per facility; 1761 MW / 40 facilities = 44 MW per

Continued

The point here is not to "prove" the continuing existence of economies of scale, but rather, to indicate that a good deal of evidence exists which is counter to the notion that the electric utility industry has exhausted economies of scale.

But, of course, scale economies are not a necessary condition for natural monopoly.

V. The Weak Natural Monopoly

In the case of the "weak" natural monopoly, where the firm has entered the range of constant or increasing long-run average costs, there is likely to be a substantial amount of additional output to be produced under conditions of economic subadditivity. Pricing at marginal cost will yield economic profits that could invite intermodal competition. But such entry would be uneconomic and a waste of society's resources.

If it seems essential that price equal incremental cost, then the policy prescription is that entry must be prevented and the firm subjected to price regulation. One could reduce monthly customer charges for service sufficient to reduce total revenues to total costs. Since the approximate demand elasticity in the customer charge is usually estimated very close to zero, small reductions in such charges would reduce revenues without inviting additional customership. Price equalling incremental cost for consumption, there would be no invitation to uneconomic usage.

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facility; 3390 MW / 126 facilities = 26.9 MW per facility. A weighted average of these various (non-exclusive) observations is 41.1 MW per facility.

VI. Unsustainable Monopoly Markets

One problem with allowing entry into monopoly markets is that firms may be induced to enter power production which will have the result of driving up the overall average cost of generating and selling electricity. Recall that a utility is required to provide not only current to a line, but also current which has some high probability of actually continuing to be there. A utility has built generating plant and transmission plant to achieve some required level of reliability. In effect, there are two products here: power and reliability.

Utilities maintain generating capacity in operating reserve status to meet unexpected increases in demand, equipment failures, and maintenance. The level of reserves needed depends primarily on the size of on-line generating units and the loss-of-load probability the utility wants to achieve. An isolated utility may determine that a particular level of reserves is needed to meet the risk of excess demand or equipment failure. The implied level of reserve capacity needed to meet the typical (high) levels of reliability is not a trivial amount. Typical levels of reserve capacity range between 15 and 30 percent of on-line generating capacity.

It is possible for someone to generate some level of power, equivalent to what the utility is selling to any customer, at a lower apparent cost than that incurred by the utility. The potential entrant is entering only the market for power. Who will provide the required reliability?

The utility could be required to provide reliability not only for the power it itself produces, but also for that which the new entrant produces. The irony is that, in such an event, the utility's costs per unit of power provided are likely to have increased. Such an increase will be due to the additional facilities required to be built because of the entrant's production, not the utility's. Additionally, as will be discussed below, the utility will have absorbed the financial risk associated with the EWG and, as a result is likely to be penalized in securities markets.

Doubtless, if the utility had acquired the additional facilities internally, some additional reserve capacity would have been necessary as well, but more coordinated facilities planning is likely to reduce the over-all cost of the bundle. In any event, no one should be so naive as to think that this EWG legislation is not the camel's nose in the tent of mandatory wheeling. Under such a scenario, the problems faced by the utility in maintaining reliability become exacerbated in the extreme.

The additional problem is that after entry, as a result of which the utility's costs may increase, it then becomes even more likely that additional entry will be sought. One might respond that such a situation can be easily dealt with: require the entrant to include in its bid the cost of a given reliability for the power under consideration. Of course, that is theoretically the answer to the problem. But if all these costs were accounted for and properly imputed to the bid, it is quite likely that one would not observe the existing enthusiasm for the EWG.

VII. Transactions Costs and the Vertically Integrated Firm

Oliver Williamson has said that "transaction costs are the economic equivalent of friction in physical systems."[21/] Transaction costs include problems such as market uncertainty and the quantity of trading partners, as well as human factors such as bounded rationality and opportunistic behavior.

A. Transactions Costs Defined

Market uncertainty refers to the fact that the future is not known within any reasonable probability. This includes future demand, costs of inputs, prices of outputs, and institutional arrangements. As a result, as William Sharkey points out, "Long-term contracts may be essential so as to economize on costs."[22/] Vertical integration occurs precisely to avoid such contracting costs.

The more firms with which any given firm must deal, the greater the number of contracts which must be negotiated, if the market is the chosen instrument of carrying out an activity. But the market may not improve efficiency as the number of contracting pairs is reduced, because a smaller number of

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[21/] Williamson, Oliver E. The Economic Institutions of Capitalism. New York: The Free Press, 1985: p. 19.

[22/] Sharkey, op. cit., p. 147.

participants results in the potential for opportunistic behavior and the use of market power.

Bounded rationality is the notion that although economic actors may intend to be rational, they intend to be so in only a limited sense. This can be interpreted as meaning limited competence. It can also mean an economizing of mental effort. In either case, some economic actors are going to perform with better results than others in any given situation.

Blair and Kaserman point out the importance of this for vertical integration:

> Because of these limits, "uncertainty" may exist at the individual level even when all relevant data are theoretically available, that is, when no market uncertainty is present.[23]

Bounded rationality involves a transaction cost, then, at the moment of negotiating a contract.

On opportunism Williamson said,

> More generally, opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse. It is responsible for real or contrived conditions of information asymmetry, which vastly complicates problems of economic organization.[24]

The difficulty which opportunistic behavior introduces into market exchange is when the likelihood of opportunistic behavior exists, transaction costs increase. Firms concerned with such behavior on the part of others must take costly precautions, e.g., negotiate detailed contracts in order to avoid being exploited by the behavior of others. In the absence, of such precautions, the market will not even pretend to deliver efficient results.

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[23] Blair, Roger D. and David L. Kaserman, The Law and Economics of Vertical Integration and Control. New York: Academic Press, 1983: p. 12.

[24] Williamson, 1985, Op. Cit., pp. 47-48.

B. The Problem of Transaction Costs

Blair and Kaserman summarize the effects or expected results from the variety of sources of transaction costs:

> ... (1) long term contracting costs are increased by the combined effects market uncertainty and bounded rationality, while (2) the costs of relying upon an equivalent series of short-term contracts are increased by the combined effects of small numbers bargaining and opportunism.[25]

In other words, vertical integration takes place because the cost of the alternative increases both with long-term and short-term contracts.

VI. The EWG Environment and Transactions Costs

A. The Putative Benefits of the EWG

To evaluate this legislative proposal, we must look to the potential benefits and the potential costs. The hypothetical benefits are derived from the increased incentives for cost minimization that one might theoretically see at the individual firm level and the closer tracking of price and marginal cost at

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25/ Blair and Kasermın, Op. Cit., p. 20.

the consumer level. Potential costs depend on the extent to which scale economies, economies of scope, economies of integration, and intra- and inter-firm cooperation are not realized under deintegration.

The putative benefits of an EWG environment depend upon the degree to which competition prevails. It must be emphasized that deregulation does not imply competition. Elements of competition must be in place prior to deregulation for the virtues of competition to be realized after deregulation.

The theoretical efficiency benefits derive from active competition. In a world of scarce resources conscious rivalry will arise among vendors. However this should not be confused with an economist's notion of competition. As Clarkson and Miller point out:

> ... jockeying for position in the car market among the big three is an example of vigorous rivalry, but the market structure is not one of perfect competition. On the other hand, perfect competition between producers may exist without conscious rivalry. Two Nebraska wheat farmers on adjacent farms are perfect competitors, but certainly are not conscious rivals.26/

Indeed, bidding for power capacity contracts may involve intense rivalry with or without the structure of competition.

What is essential is the existence of a large number of actual competitors; firms that will take serious whacks at one's

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26/ Clarkson, Kenneth W. and Roger LeRoy Miller. Industrial Organization. New York: McGraw Hill Book Company, 1982: p. 109.

market share should there be any slack in competitive performance. For competition, there must be actual competitors out there. This means relatively negligible barriers to entry so that potential competitors can freely enter the market. Conversely, there must be a relatively small barriers to exit so that firms can leave at the first sign of trouble. These conditions are necessary for the market mechanism to efficiently allocate resources among alternative uses.

That also means that there must be (1) an absence of sunk costs; (2) the absence of bounded rationality; (3) the absence of opportunism; and (4) the absence of externalities.[27]

B. The Benefits of Competition

The primary economic virtue of competition is that price equals marginal cost. An individual firm operating within a competitive market is said to be a price taker in that it takes the market price as given. With a sufficient number of firms, each firm is small enough as to have a negligible influence over market price via its production decision.

If a firm has influence over market price then there is a divergence between price and marginal cost. Since market power on the part of an individual firm is associated with the firm having influence over market price. Market power is a situation where the firm can sustain a price greater than marginal cost.

The non-competitive outcome is said to yield allocative inefficiency in that too few resources are allocated to the industry. In the non-competitive outcome, output is too low relative to the value consumers place on the good and to the cost of expanding service. By expanding output consumers are willing to pay a price at least as great as the extra cost. This output expansion happens under conditions of competition and is why competition is said to be desirable.

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[27] Williamson, Op. Cit.

C. Contestable Market Theory

In certain (very restrictive) situations the absence of a large number of actual competitors may not be necessary for the price to equal marginal cost. A market may be contestable in that the mere threat of entry may be sufficient to keep price close to marginal cost.[28/] Shepherd in commenting on the notion of contestability replaces the term "contestability" with the term "ultra-free entry".[29/] This is because the only condition in which one can theoretically predict the optimal outcome noted above are when:

1) Entry is free and without limit ...
2) Entry is absolute ...
3) Entry is perfectly reversible ... Sunk cost is zero.[30/]

In short, entry and exit conditions are such that a firm may enter the market, take the whole bundle, and leave at the first sign of trouble without incurring the transactions costs in

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[28/] Baumol, Panzar and Willig, Op. Cit.

[29/] Shepherd, William G. "Contestability and Competition" American Economic Review. 74:4 (September, 1984): 572-587.

[30/] Ibid.

the coming and going. Given ultra-free entry, the existing firm is so fearful of a new entrant(s) coming in, taking away existing market share, accruing all economic profits, then leaving, that the mere threat is sufficient to cause all existing firms to behave in an optimal fashion.

The conditions for contestability given above are reminiscent of the conditions given to us by Williamson for competition. In fact Baumol, commenting on Williamson, states that:

> If the share of relatively untransferable capital is "large", the activity belongs to the domain of transactions cost analysis. If it is "small", it falls within the territory of contestability.31/

The assumption of zero sunk cost makes ultra-free entry a useless notion for the electric utility industry. Moreover, as Shepherd observed in a footnote, raising the spectre of contracting as opposed to overt entry does not save the theory. If an entrant can offer long-term contracts to cover a given market share, how much more easily can an existing firm do so?32/

While it is true that with the discovery of the sale-leaseback technique, many kinds of corporations may suddenly find themselves in the bulk-power business, it is just as true that in the absence of the "leaseback", the "sale" would not have been

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31/ Baumol, William. "Williamson's The Economic Institutions of Capitalism." The Rand Journal of Economics 17:2 (Summer, 1986): 279-286.

32/ Shepherd, 1984, Op. Cit., p. 576, fn. 12.

consummated. Bankers, insurance agents, and shoe salesmen do not acquire large baseload generating stations for which there is not a long-term, guaranteed market. In any event, such long-term contracts would specifically constitute a violation of the "contestability" conditions. How could a market be under contract and also subject to ultra-free entry?

Shepherd observed:

> The case of a monopoly or dominant firm facing ultra-free entry is probably unstable and transient, not an equilibrium state. If costs provide for a natural monopoly, the resulting firm will create entry barriers, threaten retaliation, and generally violate the assumptions of ultra-free entry ... The case of an entry-nullified monopoly or dominant firm is unlikely to last even when it does occur.[33]

The conclusion is, then, that "contestability" or "ultra-free entry" is not a substitute for the existence of competitors in order to hope for the delivery of the many splendid outcomes of competitive markets.

D. Market Structure in the EWG Environment

If the potential benefits of deregulation stem from increased economic efficiency, then a crucial question is what degree of competition would be expected to evolve? Although legal barriers to entry in generation would be eliminated, potential entrants could face an array of economic impediments. Former FERC chairman Charles Curtis points out a few problems facing a potential entrant under a deregulation scenario:

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[33] Ibid., p. 578, (emphasis in original).

> I find it difficult to understand who it is that will enter the market to build central station facilities... . Such projects involve high front-end capital costs and long lead times ... [which] would have to be project financed and will require pay-outs in less than the 20 to 30 year period typical for utility property. Both the project financing and the shorter pay-out period will add to the costs.[34/]

This cost situation is exacerbated when one considers that economies of scale in generation are exhausted at large levels of capacity.

Investments in an efficient generating facility require from one to five billion dollars in up front costs and, as recent experience shows, these figures are subject to considerable uncertainty.

Financial commitments of this magnitude and uncertainty are rare in unregulated markets and will affect competition in two ways. First, the number of entrants will be small and probably limited to current participants in the market. Thus, tight oligopoly among a few generation firms is likely to emerge with its attendant anti-competitive results. Second, speculative investments in large new electric power facilities are unlikely. The financial markets cannot be expected to provide funds at reasonable rates for facilities offering power on the

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34/ Curtis, Charles B. "Remarks." California PUC symposium, Stanford University, March 27-28, 1981.

spot market. Instead, some financial guarantees that provide for risk sharing will have to be provided. The Edison Electric Institute summarizes the need for such agreements:

> [T]he stronger the guarantee of timely recovery of purchased power costs by distribution utilities (e.g., through automatic rate adjustments) the easier it will be to finance new generating facilities through conventional capital markets and on reasonable terms.[35]

EWG proponents concede the need for such assurance of flow-through on the part of state PUCs. The crux of this debate is what cost is the flow-through based on. Economic efficiency requires flow-through be based on marginal cost as determined in very short term spot markets. Considering the long term capital commitments which are required in generating facilities, this is not the "guarantee" that potential entrants would have in mind.

The guarantees potential firms would require to commit themselves to generating projects are more in the line of long-term contracts with the purchasing utility. Effectively, long-term contracts would serve as a substitute for existing revenue guarantees provided by a utility's monopoly franchise. One might expect that this will involve contracts stipulating, at least, minimum "take-and-pay" provisions for the facilities' output at rates which fully compensate all fixed costs and provision for expected operating costs (plus escalation).

35/ Economics Division. Alternative Models of Electric Power Deregulation. Edison Electric Institute (May, 1982): pp. VI.17-18.

Aside from the anti-competitive results to be expected from such contracts, they also have the effect of moving all of the EWG's risk on to the host utility. What happens if the EWG defaults, or does not complete the project? What happens if, in five years projected demand does not materialize? Will the utility be required to reduce its own production of energy in order to utilize the cost-plus energy of the EWG? How will this affect the utility's bond ratings?

Each of these contract characteristics will mitigate the potential competitive benefits of deregulation. "Take-and-pay" provisions hamstring the ability of host utilities to purchase from the lowest priced source of power. Fully compensatory rates blunt the incentives of the facility operator to minimize costs. Were investments frequent, this would not pose a problem since facility operators would have an incentive to build and operate cheaply in order to compete for new contracts. However, long investment life implies that contract competition will be relatively rare and reputations of facility operators will emerge slowly. Thus utilities will have little means of distinguishing efficient operators from inefficient ones at the contract negotiation stage.

The need for long-term contracts centers around the necessity of a guaranteed market so that the EWG can recover its large initial investments. Although such guarantees may be required to generate investment funds, they amount to flow-through based on average-cost pricing. This, of course, voids any notion of additional economic efficiency with respect to pricing.

If contracts are written in a manner which renders the required commitment on the part of generating firms, proponents of deregulation are placed in the following dilemma:

> Any long-term supply contract which is specific in terms sufficient to offset investor risk perceptions and provide access to capital markets on reasonable terms is also likely to have eliminated most of the incentives for producer economy and efficiency which were the original raison-d'etre for seeking deregulation and competitive markets.[36]

The need for contracts does not stem solely from the magnitude and riskiness of investments in association with new generating facilities. It also stems from the large sunk cost component of investments that are in place. An investment which has a certain value when used in the specific transaction for which it was intended which cannot readily be recovered if transferred to an alternative use becomes a sunk cost for the owner. Thus, the value of generating plants is greatest when it serves the distributor it was designed to serve and transmission facilities are specific to the individual generating plant.

Sunk costs present major barriers to entry and exit and provide potential market power to each participant in the transaction. Essentially a market which may have numerous competitive agents at the bidding stage becomes a bilateral

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36/ Ibid., p. VI.20.

monopoly with few buyers and sellers at the operation stage.

Of course, the analysis to this point indicates that there is unlikely to be "numerous" competitive agents at the bidding stage: it is likely to be a tight oligopoly. To prevent the exercise of market power *ex post*, an attempt is made to specify price and price-escalation clauses, minimum sales, and performance standards in *ex ante* contracts.

The difficulties involved in writing and enforcing contracts grow as the term of the contract increases and the relevant variables are known with less certainty. Given the long useful life of capital in electric power, contracts of twenty years or more likely will be the norm. During this time period many variables such as fuel prices and environmental regulations are extremely uncertain.

Even if one could envision short-term contracts as a viable basis upon which baseload capacity could be built, such an approach is also riddled with potential anti-competitive outcomes. Once the contract period is over and a new bidding process begins, the EWG which won the first bid has substantial advantages over potential bidders in the second round. The prior winner has the sunk cost in place. Moreover, it has the experience with the purchasing utility. The original EWG has gained crucial managerial expertise that is *specific* to the purchasing utility.

What Williamson refers to as human capital specific assets are precisely these inter-firm relationships. These also can be viewed as sunk costs which act as barriers to other firms entering the bidding process. Thus, ex-ante competition is severely thwarted at the beginning of the second round.

Even if problems with investments and contracts could be resolved, economies of scale and scope could yield the ironic result of the market evolving into even fewer firms than we see at present. If currently we see many small generating firms, then, one might expect eventually to see fewer, but bigger, generating firms.

All things considered, the EWG environment is most likely to be a tight oligopoly. The virtues of even minimal competition will not be forthcoming irrespective of the way in which the legislation defines an EWG. Moreover, the movement to such an environment can be expected to increase the cost of delivering electricity at socially determined levels of reliability.

IX. Conclusion

The unfettered marketplace is a grand experiment and provides consumers with wonderful products: computers, bluejeans, cheeseburgers, CD's and VCR's. But just as a pair of pliers is a wonderful tool for many things, you need a lug wrench to remove a flat tire. The free market is a useful tool, but it is not likely to work very well in the provision of electricity.

In an era when we are already beginning to question the wisdom of eliminating CAB regulation and the regulation of cable television, when take or pay contracts hold the potential for undoing all the good that has been derived from common carrier status for gas pipelines, do we really want impose this generic tool on our electric utilities?

UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES

TESTIMONY OF THE

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

1102 INTERSTATE COMMERCE COMMISSION BUILDING
P.O. BOX 684, WASHINGTON, D.C.

ON

TITLE XV OF S. 341
THE NATIONAL ENERGY SECURITY ACT OF 1991

MARCH 14, 1991

Mr. Chairman and Members of the Committee:

The National Association of Regulatory Utility Commissioners (NARUC) respectfully requests that this statement be entered into the Committee record for the hearing concerning Title XV of S. 341, the National Energy Security Act of 1991.

The NARUC is a quasi-governmental nonprofit organization founded in 1889. Within its membership are the governmental bodies of the fifty States engaged in the economic and safety regulation of carriers and utilities. The mission of the NARUC is to serve the public interest by seeking to improve the quality and effectiveness of public regulation in America. More specifically, the NARUC contains the State officials charged with the duty of regulating the retail rates and services of electric and gas utilities operating within their respective jurisdictions.

As the Committee is well aware, the NARUC testified on similar legislation to amend the Public Utility Holding Company Act of 1935 (PUHCA), and opposed this legislation on grounds that it lacked any of the necessary provisions to ensure State commissions' legal authority to protect the interests of retail ratepayers. In our view, Title XV of S. 341, which would exempt wholesale generators from the regulatory requirements of PUHCA, lacks these same basic provisions while adding another -- the opt-out declaration -- that would severely damage State commissions' ability to promote further competition in the regulated electric utility industry.

Given the time and effort that NARUC has put into working with the Committee staff on this legislation, we are extremely disappointed and frustrated that the NARUC was not invited to testify in person on Title XV. This contrasts sharply with the House's willingness to solicit our views on PUHCA reform legislation. Accordingly, we are concerned that the views of the collective State commissions and their effort to protect the interest of retail ratepayers are going to receive adequate consideration by the Committee in the passage of this legislation.

Title XV of S. 341 also seems to be out of step with the Administration's National Energy Strategy legislation, which includes at least one of the basic State regulatory provisions that we have called for in our 1989 **Resolution on Reform of the Public Utility Holding Company Act:** codifying the right of State commissions to regulate the wholesale purchasing practices of electric utilities that serve retail customers. Therefore, we would urge this Committee to borrow from the sensible ideas found in Title IV of the National Energy Strategy Act.

Aside from including the basic regulatory protections we have called for in the past, the NARUC is concerned particularly with the inclusion of the opt-out section of Title XV, which we urge the Committee to reject. Under Section 15003, a regulated utility may elect to file a certificate with the Federal Energy Regulatory Commission to irrevocably prohibit the utility from purchasing power from EWGs for a period of up to 10 years. State commissions would be prohibited from penalizing companies for filing the declarations, either directly or indirectly. During the period the prohibition is in effect, the filing utility and its affiliates are prohibited from owning exempt wholesale generators or EWGs.

The opt-out section is a good example of bad public policy. The practical effect of this proposal would be to stop the progress that has been made thus far to promote competition in the electric industry through all-source bidding systems that several State commissions have adopted and which other State commissions are in the process of considering. The opt-out provision also runs counter to the goals of comprehensive PUHCA reform legislation, which is to increase the entry into generation markets of EWGs.

Unfortunately, elimination of the opt-out section still does not render Title XV of S. 341 acceptable. Four basic provisions, as outlined in the NARUC resolution referred to above, must be included. A brief explanation of each of these provisions as they relate to Title XV follows:

First, Congress must "ensure the right of each State commission to review the prudence of the wholesale purchasing practices of each distribution utility subject to the State commission's authority."

The so-called "savings clause" found in Section 15004 is insufficient to ensure that State regulation is not preempted by subsequent action by the FERC or the courts. This section simply leaves the current uncertainty with respect to State regulation of wholesale purchases in place. At a minimum, this section of the bill should be amended to read "nothing in any provision of Federal law shall preempt....State regulatory authority." Clearly, it is preemption through construction of the Federal Power Act which is the issue here, and it must be addressed squarely if an industry more reliant on wholesale supply contracts is to operate in the interest of utility consumers.

Second, Congress must enact specific provisions to "preserve the right of each State commission to conduct bidding programs and least cost planning; to determine the appropriate mix of generation, as a matter of fuel and technology choice and as a matter of ownership; to take actions to insure system reliability; to restrict or prohibit affiliate transactions; and to approve or disapprove the transfer of assets from a utility to another party, free from preemption under Federal statutes or the Commerce Clause."

The purpose of this second provision of the NARUC resolution is to protect State regulators from Federal interference as they continue their efforts to adapt their methods of regulation to new types of competition in generating markets. As noted above, many States have begun processes to acquire new sources of supply through competitive bidding--a remarkable change from the way this industry has been regulated in the past. Such competitive bidding systems involve distribution utility participation in wholesale power markets. Therefore the specter of Federal preemption, either through FERC actions or judicial decisions, will be ever present.

Moreover, as we indicated in earlier testimony on the energy conservation provisions of S. 324, Title XV would undermine State commissions' adoption of least cost and integrated resource planning rules that encourage utilities to pursue energy conservation programs. It would do so by frustrating the ability of State commissions to review all the options that a utility has available in order to serve its retail customers.

Third, Congress must "provide a right of access, enabling State commissions to review the books and records of holding companies and all holding company subsidiaries, including non-regulated businesses, that transact business with the retail distribution company or EWG entity."

Our third protection would require Title XV to be amended to provide State commissions a means to enforce their subpoenas, document requests, discovery orders and the like against entities not physically present within the State, but doing business with, affiliated with, or otherwise affecting the price, supply, reliability or other relevant factors involved when an EWG sells to retail distributors. We do not intend that this protection create new substantive jurisdiction in the State commissions; rather, its purpose is to provide State commissions a procedural remedy in a Federal forum to enforce requests for information which are lawful under State law.

Perhaps the most straightforward way to implement our request would be simply to authorize Federal courts to enforce lawful State commission orders for access to the books and records of utilities, their out-of-State affiliates and EWGs. Our primary concern is Title XV places no restrictions on the creation or operation of EWGs affiliated with retail distribution utilities, thereby leaving to State commissions the responsibility and obligation to ensure that utilities do not subsidize the operations of EWG affiliates to the detriment of ratepayers and competing independent generators.

In our view, if EWGs affiliated with retail utilities are going to be allowed to enter the power generation business, State commissions, and only the State commissions, must be given the statutory right to invoke the jurisdiction of a Federal District Court within the State to enforce its subpoenas and obtain documents and testimony in order to confirm or deny allegations of cross subsidy, and for other lawful regulatory purposes.

Fourth, "in the case of an integrated multi-state holding company, [the Congress should] authorize regional compacts for those States who have jurisdiction over retail subsidiaries of the holding companies for the sole purpose of regulating the allocation of costs and/or the prudence of wholesale power purchases by the holding company."

This last protection is intended to address the difficult issues raised when integrated multi-state registered holding companies participate in wholesale power markets. Under the Supreme Court's decision in Mississippi Power & Light, such companies may be able to purchase power from affiliated and unaffiliated EWGs with no State regulation of their purchasing decisions. To avoid State prudence regulation, a holding company could simply purchase power from third parties through an affiliate which is not subject to the regulatory authority of the State commissions in whose jurisdictions it operates retail subsidiaries. Under the logic of MP&L, the States would be required to pass through the costs of purchased power once they had been allocated to the operating subsidiaries by an FERC allocation order.

In a resolution adopted by the NARUC Executive Committee at its recently concluded Winter Meeting, we proposed to fill the regulatory gap that exists between State and Federal regulation by amending the Federal Power Act. A copy of this resolution is attached to this testimony. This legislation would authorize the States in which the holding company operates to form regional regulatory bodies to review the prudence of any wholesale purchases the company may make for its system supply, i.e. to meet the collective need for power of its subsidiaries rather than an individual operating subsidiary's needs. These bodies would be formed voluntarily by the States, and if they so chose, they could regulate not only the prudence of wholesale purchases but could also allocate the costs of the purchases among the retail distribution subsidiaries. We would propose that no regional body could be established unless all of the States agreed.

This resolution would also call on Congress to authorize the creation of multistate compacts that would oversee the siting and certification of interstate transmission facilities.

In conclusion, the NARUC is opposed to Title XV in its present form, and urges the Committee to amend this legislation as we have indicated in our testimony. Without addressing the concerns of State commissions, this legislation would fail the test of serving the public interest. The NARUC appreciates the opportunity to submit this written testimony.

Resolution Endorsing Legislation to Amend the Federal Power Act to Reform State/Federal Jurisdiction

WHEREAS, *In enacting the Federal Power Act in 1935, Congress granted the Federal Power Commission, predecessor to the Federal Energy Regulatory Commission (FERC), jurisdiction to regulate the wholesale sale and transmission of electricity in interstate commerce while preserving State jurisdiction over local rates and services of utilities; and*

WHEREAS, *In 1964, the U.S. Supreme Court held in Federal Power Commission v. Southern California Edison Co., 376 U.S. 205 (1964) (the Colton case) that Federal jurisdiction over wholesale sales included entirely intrastate wholesale transactions, thereby extinguishing State intrastate wholesale authority; and*

WHEREAS, *In a series of decisions culminating in its decision in Mississippi Power & Light v. Mississippi ex rel. Moore, 487 U.S. 354 (1988), the Supreme Court has sharply restricted the authority of the States to regulate the passthrough in retail rates of a utility's FERC-regulated costs of power purchased at wholesale; and*

WHEREAS, *Despite these decisions, the bulk of electric power costs and rates are determined by State regulatory commissions, including the costs of facilities used to provide wholesale sales and transmission service for which FERC establishes rates and conditions of service. Moreover, States retain exclusive jurisdiction over the siting of transmission facilities used for both inter and intrastate service; and*

WHEREAS, *In recent years, the electric utility industry has undergone substantial change as a result of increased reliance on wholesale power suppliers, including non-utility generators, greater regional coordination of power supply planning and operations, mergers and consolidations of utility operations in multiple jurisdictions, and increased transmission access by third parties. As a result, the FPA's jurisdictional allocation of authority is no longer consistent with the manner in which the industry now operates; now, therefore, be it*

RESOLVED, *That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), convened at its Winter Meeting in Washington, D.C., hereby calls upon Congress to amend the Federal Power Act in order to reform State and Federal jurisdiction over electric utility transactions to conform to the operational reality of the industry; and be it further*

RESOLVED, *That such amendments to the Federal Power Act be based upon the following principles:*

1. *Jurisdiction over the retail rates and services of electric utilities shall remain with the States. Such jurisdiction must be strengthened to affirm the authority of the States to regulate the passthrough of purchased power costs in the retail rates of utilities;*

2. Jurisdiction over intrastate wholesale sales and transmission rates, terms and conditions should be returned to the State regulatory commissions;

3. Jurisdiction over multistate transactions (including system cost allocation, bulk power purchases and sales, emission allowance allocations, and use of transmission facilities) within registered holding company systems operating should be lodged in regional regulatory bodies authorized by Congress and established on a purely voluntary basis by the States in which the systems operate. In the event such regional bodies are not formed, or if formed, decline to regulate given issues, jurisdiction shall be lodged in the FERC except to the extent the electric utility subsidiaries of such holding companies are exempt from FERC jurisdiction over such issues pursuant to Section 201 of the Federal Power Act, 16 U.S.C. sec. 824, or successor provision(s). Jurisdiction over multistate transactions of other utility systems should also be exercised by such voluntarily-established regional bodies, but without default to FERC.

4. Congress should authorize the creation of multistate compacts consistent with basic principles of administrative efficiency and fairness. States which voluntarily form such compacts would collectively determine rules of governance and internal procedures; and be it further

RESOLVED, *That the following principles govern the siting of transmission facilities to be used in multistate transactions:*

1. States exercising jurisdiction over the siting and certification of transmission facilities should not discriminate against interstate facilities, meaning that interstate facilities should be sited, certificated, and otherwise regulated under the same standards and procedures as intrastate facilities.

2. States should retain jurisdiction to make all factual determinations concerning transmission siting. Judicial review of such determinations, whether in State or Federal courts, should not be de novo, assuming the States have conducted evidentiary proceedings.

3. Congress should authorize the creation of multistate compacts which permit willing States to:

a. Identify regional bulk power market needs for State siting agencies to consider in their respective deliberations; and

b. Plan for the construction of new interstate transmission facilities.

4. Congress should further authorize the creation of multistate compacts which permit willing States in which an interstate transmission facility is proposed to be sited:

a. To issue certificates authorizing the construction of the proposed facility; or

b. If States choose to retain certification authority for themselves, to agree upon and employ a mechanism for a final, binding resolution of a proposed facility siting when the individual States involved have come to conflicting and/or inconsistent determinations in their respective deliberations.

Sponsored by the Committee on Electricity
Adopted February 27, 1991
Reported NARUC Bulletin No. 9-1991, pages 22-23

UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES

TESTIMONY OF THE

ARKANSAS PUBLIC SERVICE COMMISSION
P.O. BOX 400
LITTLE ROCK, ARKANSAS 72203
TELEPHONE (501) 682-1453

SAM I. BRATTON, JR., CHAIRMAN
PATRICIA S. QUALLS, COMMISSIONER
JULIUS D. KEARNEY, COMMISSIONER

ON

PROPOSED AMENDMENT OF
THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935:
TITLE XV OF THE NATIONAL ENERGY SECURITY ACT OF 1991 (S.341)

MARCH 13, 1991

Mr. Chairman and Members of the Committee:

The Arkansas Public Service Commission (APSC) appreciates this opportunity to submit written testimony on Title XV of the proposed National Energy Security Act of 1991, relating to amendment of the Public Utility Holding Company Act of 1935 ("PUHCA" or "the Act"). The APSC is one of five jurisdictions regulating Entergy, a registered holding company. Arkansas Power & Light (AP&L), one of Entergy's operating subsidiaries, serves approximately 30% of Entergy's total load. AP&L has 596,000 customers, 95% of whom live in Arkansas.

Unlike most utilities, a utility subsidiary of a registered holding company incurs most of its power supply costs by purchasing capacity and energy from other subsidiaries of the holding company. These wholesale transactions are regulated by the Federal Energy Regulatory Commission (FERC), rather than state commissions. Recent judicial decisions concerning the treatment of these wholesale transactions have placed the future of state regulation in doubt, even as states are creating innovative means to encourage efficient, least cost planning, and competition among sellers of power.

Title XV would lead to many more wholesale transactions, thus multiplying the current level of uncertainty. Enacting Title XV without creating a predictable, rational relationship between federal and state regulation, and without ensuring that essential transmission facilities are available to all wholesale competitors, will hamper state efforts at least cost planning and leave the industry operating less efficiently than it does now.

JURISDICTIONAL UNCERTAINTY IS HAMPERING STATE COMMISSION EFFORTS TO PREVENT RECURRENCE OF THE UNNECESSARY CONSTRUCTION OF THE LAST DECADE

States are currently suffering under the weight of costly utility construction errors. In the case of Arkansas, the allocation by the Federal Energy Regulatory Commission (FERC) of 36% of Entergy's Grand Gulf Plant has forced our ratepayers to pay roughly $1.224 billion more than they would have had the holding company acted consistently with its original agreement to assign 0% to Arkansas. The controversy over this $3.8 billion plant has dominated relations between regulators and the holding company throughout the region.

Integrated resource planning is one means to prevent the recurrence of these mistakes. As described by some of its leading practitioners, integrated resource planning is a process by which utilities and their regulators "explicitly and consistently assess a variety of resources to meet customer energy-service needs cost-effectively." The process (1) "considers a broad range of supply, demand, transmission and distribution, and rate-design options;" (2) "requires integration among different departments and people within the utility;" (3) "identifies and analyzes the key factors which are uncertain and [which] affect resource-acquisition decisions;" and (4) "maintains an ongoing review and adjustment of the plan as events and opportunities change." [1]

State regulators of registered holding companies lack undisputed authority to conduct integrated resource planning: Integrated resource planning requires direct action by, and collaboration between, state regulators and utilities. To bring discipline to the process, state commissions need legal clout. But uncertainty over state legal authority, including the threat of federal preemption, is hampering states' ability to bring integrated resource planning to registered holding company systems. Put another way, integrated resource planning requires state-based comparison of generation, conservation and load management options. It is not possible to conduct this comparison on a state-by-state basis when the in-state subsidiary takes orders from a multistate parent. The current legal uncertainty is exemplified by the Supreme Court's decision in Mississippi Power & Light.

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[1] Hirst and Schweitzer, "Uncertainty: A Critical Element of Integrated Resource Planning," The Electricity Journal 16-17 (July 1989).

In Mississippi Power & Light v. State of Mississippi ex rel. Moore, 487 U.S. 354 (1988), the Supreme Court found that a FERC decision allocating capacity among the four utility subsidiaries of a centrally planned holding company preempted a state commission from questioning the prudence of one of those subsidiaries in acquiring that capacity. As a result of Mississippi Power & Light, the future of state regulation is in doubt. Wholesale transactions approved by FERC will, under certain circumstances, preempt state decisionmaking. Those circumstances are far from clear. What is clear is that the creation of wholesale affiliates necessarily will produce an increase in wholesale transactions. Some of those transactions may fall within the centrally planned variety which triggered Mississippi Power & Light preemption. Others may not.

There is substantial dispute among lawyers as to the boundary between preempted and non-preempted transactions. Only Congress can clarify the matter, because it is Congress' enactment -- the Federal Power Act -- that is causing the preemption. Until Congress clarifies the law, every new wholesale affiliate creates the risk of further erosion of traditional state jurisdiction.

And creation of wholesale affiliates is what this bill is all about. Without any advance review by the SEC under PUHCA, existing utilities can create wholesale affiliates and conduct transactions with them. Mississippi Power & Light created enough difficulty by itself and necessitates a legislative solution. But the elimination of PUHCA review magnifies the problem: States not only would have lost their own forums; they would lose the PUHCA forum as well.

Section 15004 of the proposed legislation, which purports to protect state jurisdiction, provides no help. That Section states:

> Except as provided in section 15003, nothing in this title shall preempt or otherwise restrict such power as a State commission may have, in accordance with State and Federal law and in the absence of the enactment of this title, to judge the prudence of a purchase of electric energy at wholesale, allow or disallow the inclusion of the cost of such a purchase in rates subject to such commission's jurisdiction, or otherwise exercise its functions." (emphasis added)

The risk is not that there will be preemption by this title, i.e., the PUHCA amendment; the risk is that there would be preemption by the Federal Power Act as a result of wholesale transactions facilitated by "this title." No participant in the current debate believes that Section 15004 will have any effect on the risk of preemption created by Mississippi Power & Light.

The Pike County Doctrine Does not Clearly Protect State Regulation of Registered Holding Companies. In Pike County Light & Power v. Pennsylvania Public Utility Commission, 465 A.2d 735 (Pa.Cmwlth. 1983), a Pennsylvania lower court found that a state commission was not preempted from disallowing the costs incurred by a utility purchasing power from an affiliated utility pursuant to a FERC-approved wholesale rate. The Court found that FERC's authorization of the seller to charge a particular rate did not obligate the buying utility to purchase from that seller; therefore the state regulating the buying utility's retail rates was free to inquire into the prudence of the buying utility's actions. [2]

The factual premise for the holdings in Pike County and Kentucky West Virginia is that the buying utility had a mind of its own. That is, the buying utility had no preexisting obligation to enter into the contract whose justness and reasonableness were affirmed by FERC. Because the buying utility was legally free to make its own decision when it entered into the FERC-approved wholesale contract, it was able to distinguish between prudent and imprudent choices. Therefore, the state was free to determine whether the buying utility's actions were prudent or imprudent.

In a Mississippi Power & Light context, the facts are likely

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[2] See also Kentucky West Virginia Gas Co. v. Pa. Public Utility Commission, 837 F.2d 600, 609 (3d Cir. 1988) (preemption under the Federal Power Act "in no way undermines the long-standing notion that a state commission may legitimately inquiry into whether the retailer prudently chose to pay the FERC-approved wholesale rate of one source, as opposed to the lower rate of another source.").

to be different. Due to a preexisting systemwide agreement, the utility subsidiaries are not free to reject a sale from another affiliate, in favor of some other purchase. Because in these circumstances the buying utility has no freedom of action, it is difficult for a state commission to declare that the buying utility has acted prudently or imprudently. Within the current factual and legal contexts, the logic of Pike County is difficult to apply in these situations.

In Any Event, Utilities are Still Contesting the Validity of the Pike County Doctrine. There is a disturbing failure by some utilities to accept the clear logic of Pike County. For example, Kansas Gas & Electric Company is challenging a Kansas Corporation Commission decision involving KG&E's capacity sale to another utility at a price lower than the cost to Kansas ratepayers of the KG&E capacity which made the sale possible. The KCC set KG&E's retail rates as if KG&E had earned revenues from the sale equivalent to the costs imposed on the state ratepayers, on the grounds that KG&E was free to seek a higher price from the buyer. The KCC's reasoning was not substantially different from the reasoning underlying Pike County. Yet KG&E is petitioning the U.S. Supreme Court to overturn the Kansas Supreme Court decision affirming the KCC. [3]

And just last week, the Pennsylvania Supreme Court heard a challenge by Pennsylvania Power Company to a state commission decision disallowing 90% of the costs incurred when Penn Power purchased capacity and energy from Cleveland Electric Illuminating (CEI). Under a FERC-approved contract, Penn Power had transferred a share of the Perry 1 Nuclear Plant, agreeing to buy back from CEI the capacity energy associated with the plant for 18 months. The Pennsylvania Public Utility Commission found that Penn Power had made no showing that the capacity purchase was needed; nor that, if the capacity were needed, that less expensive power was not available. Consequently, the state commission disallowed about $16 million of the $18 million incurred. A lower court upheld the commission's decision. Pennsylvania Power Co. v. PA. P.U.C., 561 A.2d 43 (Pa. Cmwlth. 1989). This decision was a classic Pike County situation; yet the company now has appealed the case to the state Supreme Court.

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[3] Kansas Gas and Electric Company v. State Corporation Commission of the State of Kansas, U.S. No. 90-984, petition for writ of certiorari filed, December 19, 1990.

The New Regime of Emissions Trading Increases the Jurisdictional Uncertainty for States Regulating Registered Holding Companies. The uncertainty over power supply transactions within registered holding company systems replays itself in the area of emissions trading. Specifically, the recent enactment of Clean Air legislation created opportunities for utilities to engage in so-called emissions trading. Emissions trading may lead to efficient mechanisms for reducing pollution. But because emissions trading involves wholesale transactions among utilities, it adds to the regulatory uncertainty for all states, particularly states who regulate the registered holding companies.

Registered holding companies will control about 25% of the emissions allowances by the year 2000. These registered companies generally plan generation and transmission on a centralized basis pursuant to FERC-approved system wide agreements. Although language in the Clear Air Bill preserved the so-called "jurisdiction status quo" between federal and state regulation, some have argued that that status quo includes the existing law of federal preemption of state regulation.

For example, Joseph Dowd, General Counsel of American Electric Power, a registered holding company, recently stated:

> A respectable legal argument can be made that this new federal law has created a comprehensive, pervasive national emissions trading program which, in order to work properly, has to be free of parochial state regulation. That argument leads to the conclusion that state regulation would be subject to implied federal preemption.[4]

According to Mr. Dowd, if generation and transmission is centrally planned, then Acid Rain compliance should be centrally planned as well. When the utility subsidiaries of registered holding companies overcontrol plant emissions, the resulting allowances

> should be placed in system-wide pools and deployed on system-wide bases in order to achieve least-cost compliance also on system-wide bases. And this in turn ... suggests that the pricing of those system pool allowances should be subject to FERC's exclusive jurisdiction under the Federal Power Act, just as the transfer of electric energy among system companies is subject to such jurisdiction. In our view, the pricing of intra-system allowance transfers ... would involve the question of equitable sharing of costs and benefits among members of an integrated system -- and cost allocation questions of this type have been held by the U.S. Supreme Court to be subject to the exclusive jurisdiction of the

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[4] See Electric Utility Week, November 19, 1990.

FERC." [5]

Transactions involving emissions allowances can have significant effects on the cost of utility service. State commissions need jurisdiction to determine the prudence of emissions transactions. In light of the jurisdictional uncertainty described above, the APSC has several questions which require answers, including the following:

1. When the electric utility operating a generating unit is a subsidiary of a holding company, it is not clear whether the operating subsidiary company or the parent company will own the emissions allowances for a generating unit.
2. For a registered holding company, capacity additions are planned on a system basis, but still certificated in the state where the unit will be located. In this situation, it is unclear in which jurisdiction the emissions compliance plan for a new unit would be filed.
3. For some holding companies, certain generators are owned not by a utility subsidiary regulated by a state commission, but by a central generation subsidiary regulated by FERC, which subsidiary then sells power to state regulated utility subsidiaries. In this situation, it is unclear where the emissions compliance plan would be filed and who would have jurisdiction over it.
4. When a generating unit is retired, it is not clear whether the allowances associated with that unit revert to the operating subsidiary company or to the parent company.

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[5] Id. Similarly, an attorney representing registered holding companies recently emphasized that the U.S. Supreme Court's interpretation of the Federal Power Act, as set forth in Mississippi Power & Light, "make it clear" that in the context of emissions trading among the utility subsidiaries of a registered holding company, "state utility commissions must abide by the conclusions reached by the Federal Energy Regulatory Commission on the allocation and pricing of allowances." C. Patrizia, "Multistate and State/Federal Conflicts Facing the Electric Utility Industry As A Result of the Clean Air Act Amendments of 1990," Speech to NRRI Workshop on Implementing Electric Utility Provision of the Clean Air Act Amendments of 1990 (Jan. 31, 1991).

The emissions trading provisions of the Clean Air Act permit utilities to reallocate their allowances within their respective systems without approval of the Environmental Protection Agency. As Charles Gray, Assistant General Counsel for the National Association of Regulatory Utility Commissioners, has explained,

> a utility with a number of SO2 emitting plants can take allowances issued in the name of one plant and use them to offset emissions from another facility. For example, a utility could overcontrol its emissions in State A and use the "excess" allowances to avoid making reductions in State B. There could be very good reasons for this sort of reallocation due to differences in compliance costs at various plants. However, the regulatory issues are difficult but important: Should the ratepayers in State A be required to pay the costs of overcontrol while the State B ratepayers escape the compliance costs they would otherwise pay? If the State B ratepayers are to pay for the allowances reallocated to their service territory, how much should they pay? A's costs of overcompliance? A market-derived price?"[6]

Assume a holding company does have the authority to direct the transfer of emission allowances from an operating company in state A to another operating company in state B. If so, then when the utility in state B sells the transferred allowances through the allowance trading program, the profit from the sale would go to state B rather than state A, even though state A's ratepayers may have put up the costs to build the plant to begin with.

A related question arises when the holding company directs the operating company in state A to "overcontrol" a facility in order to create extra allowances to transfer to other states. The costs of overcontrolling may fall on ratepayers in state A, in order to reduce pollution costs in the other states. This result would be inequitable.

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[6] "The Clean Air Act Amendments of 1990: Acid Rain Caps and Trading SO2 Allowances - The Role of State PUCS."

The proposed changes to PUHCA create more opportunities for such uncertainty. For example, a registered holding company could create a new wholesale generating entity to construct a coal plant for the purposes of off-system sales. The holding company then could direct one of the utility's subsidiaries to transfer valuable emissions allowances, currently held by that utility subsidiary, to the new wholesale generator. The state commission regulating the utility subsidiary may believe that the subsidiary received too low a price for the allowances, and may wish to impute for retail rate purposes a higher level of revenues. However, if the transfer of allowances occurred pursuant to a FERC-approved, system-wide agreement, the state commission may have no jurisdiction.

To make matters worse, when the utility subsidiary itself needs to add new generation (because of either load growth or plant retirements), the subsidiary may lack sufficient allowances to permit the construction of the new plant. At that future time, the utility subsidiary may have to pay some premium to acquire the allowances on the market, or, ironically, from the new wholesale generator. In effect, the registered holding company would have used its corporate structure, in conjunction with the weakening of PUHCA, to strip away valuable assets from the utility subsidiary. Because the holding company can create the new wholesale generating company without any advance review under PUHCA, the state commission may lack any opportunity to protect itself.

This practice can weaken competition as well as state regulation. Armed with these new allowances, the wholesale generator would have competitive advantages over independent entrants into wholesale power supply markets. In effect, the registered holding company under this bill can use its captive retail customers to subsidize its anticompetitive entry into wholesale bulk power markets. It is precisely that practice which PUHCA guards against today.

JURISDICTIONAL UNCERTAINTY IS COMPOUNDED BY ONGOING RESTRUCTURING OF REGISTERED HOLDING COMPANIES

The structure of the Entergy system is undergoing significant change, adding to the jurisdictional uncertainty created by Mississippi Power & Light. For example:

1. Entergy has transferred all its nuclear operations activities, presently decentralized in each utility subsidiary, to a single division of the holding company. The nuclear management company, named Entergy Operations, Inc., has assumed operating responsibility for ANO, Waterford 3, and Grand Gulf 1, subject, respectively, to AP&L, LP&L, and System Energy's oversight.[7]

2. The holding company plans to consolidate non-nuclear operations as well by transferring operational responsibility from the utility subsidiaries to a central office in New Orleans. Moreover, Entergy recently announced that more than 200 employees from Arkansas and Mississippi would be transferred to a new office near New Orleans, where the holding company's headquarters are located.

3. Arkansas Power & Light also is seeking regulatory

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[7] See Entergy Corporation 1989 Annual Report, pp. 50-51. According to holding company officials, the ultimate plan is to consolidate all generation and transmission activities, presently conducted at the utility subsidiary level, to the holding company level. Under the current legal environment, these moves place the future of state regulation in doubt.

approval to sell its Missouri retail operations to Union Electric Company of St. Louis.

4. Entergy also has created a Distribution and Customer Service organization headquartered in Arkansas that will consolidate the retail practices and strategies for the entire system.

5. Last November, when Entergy increased its dividend by 20%, holding company officials indicated their strong interest in using the holding company's extra cash flow to make new acquisitions and investments.

If the goal of this restructuring is to streamline operations and cut costs, we would applaud it. But if the goal of the restructuring is part of a larger plan to make regulatory tracking more complex by centralizing retail costs within wholesale subsidiaries of the holding company (possibly, beyond the reach of state regulators due to Mississippi Power & Light), we would oppose it, vigorously.

We are not certain of Entergy's goals. Because of our uncertainty concerning Entergy's goals, we need certainty concerning state regulatory jurisdiction, as well as the regulatory backstop furnished by Public Utility Holding Company Act.

THE PROPOSED LEGISLATION EXACERBATES THE UNCERTAINTY BY MAKING FORUM SHOPPING EASIER

Title XV, by permitting the creation of wholesale generating entities without review under the Act, will encourage many more wholesale transactions, both within a registered holding company system and between that system and unaffiliated entities. The APSC is concerned that these new transactions will continue the present trend toward erosion of state regulatory jurisdiction. Indeed, Entergy has begun a series of meetings with state regulators aimed at discussing the potential for least-cost planning on the holding company system. While most people support least-cost planning, it is difficult to have these discussions without knowing if the state has regulatory authority.

We are aware of one proposal other than Title XV, which state that where there is an interaffiliate transaction within a registered holding company system, the questions surrounding such transaction have been resolved jointly by all affected State Commissions, a rebuttable presumption should attach in any FERC proceeding to determine the justness and reasonableness of the transaction. This proposal does not resolve the uncertainty associated with the "FERC default" element of a regional regulation scheme.

Some have proposed to codify not only Pike County, but Mississippi Power & Light as well. One proposal to codify Mississippi Power & Light which we have reviewed states as follows:

> The jurisdiction of the Commission under this Act to decide the lawfulness of an affiliate rate or charge shall include the exclusive power to determine: (1) the prudence of the purchase of electric energy by an affiliate or affiliates of a registered holding company from another affiliate or affiliates of such holding company; (2) the prudence of the purchase of electric energy by more than one affiliate of a registered holding company from a person who is not an affiliate of such holding company; and (3) the allocation of cost responsibility when any purchases referred to under (1) or (2) are made by more than one such affiliate. Any determination by the Commission of prudence or cost allocation under this subsection, shall be binding on a State commission for purposes of the inclusion of the cost of electric energy purchases at wholesale in rates subject to such State commission's jurisdiction.

The APSC's goal is to modify Mississippi Power & Light; not to codify it. This language moves in the opposite direction, in at least three ways:

1. It expands federal preemption beyond facts of Mississippi Power & Light. The foregoing language makes a FERC decision preemptive for every wholesale transaction between two affiliates. Mississippi Power & Light involved a far more stringent test for preemption: not only must a transaction be between affiliated entities; it must be pursuant to a system-wide plan previously approved by FERC. Ironically, Pike County itself, which establishes the right of state commissions to disallow a utility buyer's costs incurred in a FERC approved sale, involved an affiliated transaction. Consequently, the foregoing language not only would codify Mississippi Power & Light; it would apply Mississippi Power & Light to Pike County situations and thereby repeal Pike County as well.

2. The language would preempt a state commission from questioning the prudence of an affiliate's purchase from a non-affiliated company, where the affiliate was joined by one or more other affiliates in the purchase. Given that all affiliates in a holding company must obey the mandates of the holding company,[8] it would be easy to ensure that for any single affiliate's purchase, a second affiliate could join by purchasing a nominal

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[8] See North American Company v. SEC, 327 U.S. 686, 692-93 (U.S. 1946) ("The dominant characteristic of a holding company is the ownership of securities by which it is possible to control or substantially to influence the policies and management of one or more operating companies....").

amount. Mississippi Power & Light did not involve that type of situation.

3. The language appears to preclude a state commission from questioning the prudence of an affiliate's handling of capacity acquired pursuant to a FERC-dictated sale. Assume that Arkansas Power & Light (AP&L) was bound by, which it now is, a FERC decision to take a specific quantity of Grand Gulf capacity from an affiliate. Assume further that as a result AP&L now has excess capacity relative to its own load. We as state regulators now would expect AP&L to make vigorous efforts to sell that excess to others. AP&L's failure to do so should result in our imputing, for retail rate purposes, an amount of revenues reflecting any sales which a prudent utility could have made. The foregoing language seems to preclude that result. [9]

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[9] New Orleans Power Service Company v. Council of City of New Orleans, No. 88-348 (U.S. June 19, 1989). In that case, the city council, acting as retail rate regulator, attempted to inquire into whether a holding company affiliate had managed its Grand Gulf excess prudently. In dictum, the Court stated:

> The Council has not sought directly to regulate interstate wholesale rates; nor has it questioned the validity of the FERC-prescribed allocation of power within the Grand Gulf system, or the FERC-prescribed wholesale rates; nor has it reexamined the prudence of NOPSI's agreement to participate in Grand Gulf 1 in the first place. Rather, the Council maintains that it has examined the prudence of NOPSI's failure, after the risks of nuclear power became apparent, to diversify its supply portfolio, and that finding that failure negligent, it has taken the normal ratemaking step of making NOPSI's shareholders rather than the ratepayers bear the consequences. Nothing in this is directly or even indirectly foreclosed by the federal statute, the regulations implementing it, or the case law applying it.

CREATIVE SOLUTIONS ARE NECESSARY

As a state commission trying to regulate a utility subsidiary of a registered holding company, we intend to join those seeking creative solutions to these complex problems. In particular, any proposal must have the following characteristics:

1. Jurisdiction should be predictable.
2. Jurisdiction should be commensurate with the appropriate planning region.
3. States should remain free to choose their own mix of fuels, conservation and load management.

Questions Raised by the Regional Board Approach: Some, including the National Association of Regulatory Utility Commissioners, have proposed regional boards to regulate the activities of registered holding company systems. We think there is merit in considering this option. But the idea needs much more discussion before we can be sure it can work. We are not sure that a regional board, in and of themselves, can easily solve power supply planning problems on a registered holding company system. In order to advance the debate, we take this opportunity to set forth some of our concerns.

1. Regulation must be guided by objective principles. In allocating costs among the states on a multistate system, regulators must adhere to predictable rules that can be applied in future cases. In a multistate regional board, however, each member might feel compelled to vote his or her home state's interests, rather than follow an objective rule. The result would resemble a regional legislature not a regional regulator. We therefore must

work to develop clear standards and methodologies to be used by any regional board.

2. It is by no means clear that the specific regions served by existing registered holding companies bear any relationship to effective planning regions. Registered holding companies are historical accidents. Congress' intent in enacting PUHCA in 1935 was to break up the 13 holding companies which controlled the industry into local utility systems. In the long process of litigation that accomplished this result, certain entities managed to remain large and spread over several states. In today's industry any individual subsidiary of a multistate company may be able to coordinate and plan with adjacent unaffiliated utilities just as easily as they can coordinate and plan with the affiliated utilities in their registered system. There is some risk that by effectively requiring subsidiaries to coordinate with their affiliates, we forego more efficient coordination with the non affiliates. We should make these coordination and planning decisions on a case-by-case basis, rather than be ruled by system boundaries mapped out 40 or 50 years ago.

3. The notion that the failure of a regional board to act within a certain number of days moves jurisdiction to FERC is controversial. Regulation is effective when regulation is predictable. The jurisdiction should not shift with the hour glass. If regional regulation is the proper approach, we should insist on regulation; not permit the form to slip to FERC when some people's patience runs out. Regulation is effective when the staff

is experienced. If we don't know for any particular proposal whether the form would be the regional board or FERC, there will be no incentive to create and develop a permanent staff prepared to deal with the issues. Moreover, regional regulators pressed by the deadline may agree to deals inconsistent with objective regulatory principles, merely to avoid the "specter of FERC preemption." Similarly, utilities who prefer FERC may include complicating factors in their proposals so as to ensure that the deadline for FERC default will arrive before the regional regulators fashion a solution.

4. What region would be regulated by the regional regulators? To form a regional board consisting of the states regulating existing registered holding companies is to beg the key regulatory question: What is the appropriate planning region?

5. Creation of a regional board does not explain how a single state with a unique fuel resource (or willingness to undertake conservation or load management measures) can pursue these alternatives while remaining consistent with the dictates of a regional plan. Suppose, for example, that the efficient size for a proposed baseload plant required the participation of all four states in a region. Suppose further that one of the states preferred not to participate because it had a unique resource (e.g., a potential hydroelectric sight) within its borders. Must that state forego the hydroelectric sight and pay more by participating in the regional power plant? Or may the state exploit its own resource, thereby forcing the other three states to

bear higher costs through excess capacity or a less efficiently sized plant?

6. Some believe that a regional board should not be created unless there is unanimous consent among the retail regulators of the holding company's operating subsidiaries. It certainly is difficult to imagine a regional board operating well unless each state participated voluntarily. But the requirement of unanimous consent exposes another problem: a holding company fearful of the scrutiny expected from a regional board could offer the smallest state sufficient concessions to persuade that state to withhold its consent. In this matter, the registered holding company can purchase guaranteed FERC preemption for a low price.

7. Some proponents of a regional approach also suggest that each affected state would have an equal vote in determining the outcome of regional allocations. This rule would invite states with small loads to dictate the costs for states with large loads. Another version would permit three states to dictate the costs to a fourth state. This result may more resemble regional legislating than regional regulation.

8. One proposal also indicates that regional issues requiring factual findings first would be referred to a FERC Administrative Law Judge for an Initial Decision, which decision then would be reviewed by the regional board. This procedure suggests several questions.

a. It is not clear what role the individual states would play in the proceeding before the ALJ. Would states litigate their individual decisions against each other before the ALJ; and then, after the ALJ decision, convene as a regional board to determine whether to accept or modify the ALJ decision?

b. Would the regional board be bound by the ALJ's factual findings? If so, what issues would be left for the states to determine within the regional board? If not, what purpose would be served by having a trial before an ALJ?

c. If the states could not reach agreement as a regional board, would they return to their litigation positions and take exceptions to (or support) the ALJ decision before FERC?

d. Finally, if some states disagree with the FERC decision, would the states take their differences to the Court of Appeals, and possible to the U.S. Supreme Court? If the answer is "yes," the situation would resemble strongly the situation today, with one difference: if the states could agree to a position early in the process, they could impose that position on each other and on the company, without FERC participation.

Congress Needs to Enact a National Policy of Nondiscriminatory Transmission Access: We agree strongly with those who insist that there cannot be competition or least-cost planning unless all competitors have fair access to essential transmission facilities. Arkansas cannot institute least cost planning if the least-cost generators are barred from transmission by higher cost competitors. Effective least-cost planning requires fair competition. Fair competition is not possible if we leave control of transmission policy in the hands of only some of the competitors -- those who happen to control the transmission highways.

We also agree with those who say that the so-called "voluntary" transmission is not sufficient. As state regulators, we know how easy it can be to encourage a utility to emphasize its own short term interest, at the expense of the broader interest.

To some extent, utilities' anti-competitive behavior is a response to concerns that state regulators would frown on the sharing in-state resources with out-of-state interest. [10] But that type of regulation is shortsighted. Any particular state can benefit from its provincialism today, but suffer from another state's provincialism tomorrow. A national policy requiring pro-competitive transmission access would assure that no state takes advantage of a short term situation to the detriment of others.

CONCLUSION

Reconciling state-federal jurisdictional relations with the developing regional bulk power markets presents a significant public policy challenge. We again congratulate the Chairman and this Committee for initiating this debate, and appreciate this opportunity to present our views. We look forward to more such opportunities in the future.

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[10] See Strategic Decisions Group, Western Systems Power Pool Assessment (Final Report), p. ES-10 (January 1991). This report was prepared for the sponsors of the Western Systems Power Pool. Attempting to explain the refusal of some utilities to transmit power for others, the report's authors suggested that utilities' insistence on above-cost transmission prices "appeared to be motivated" by a desire to satisfy state regulators.

APPA

American Public Power Association

2301 M Street, N.W.
Washington, D.C. 20037-1484
202/467-2900

Testimony of
The American Public Power Association
for the
Senate Energy and Natural Resources Committee
Hearing On
The Public Utility Holding Company Act

March 14, 1991

SUMMARY

Title XV of S. 341, the National Energy Security Act of 1991 is not a simple, rifleshot amendment to the Public Utility Holding Company Act of 1935 (PUHCA). Rather, Title XV is a radical proposal that:

- permits the restructuring of the electric utility industry and would create **less, not more, competition** in the wholesale generation market;
- provides **more** opportunities for and less consumer protections from **utility abuses of self dealing and cross subsidization within the holding company system;**
- shifts **risks** from stockholders **to ratepayers** without offering corresponding benefits; and
- could cost **ratepayers billions of dollars** annually on top of present payments.

In addition, the provision is unnecessary to nurture an already flourishing independent power market whose development could best be enhanced without consumer risk by nondiscriminatory transmission access.

The American Public Power Association (APPA) is the national service organization representing more than 1,750 locally-controlled public power systems. APPA believes that the Public Utility Holding Company Act of 1935 is an important consumer protection statute that structures and regulates the electric utility industry to protect ratepayers and consumers from monopoly abuses. Public power systems -- in particular the more than 900 systems that purchase power at wholesale from investor-owned utilities (IOU) -- have

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benefited for over 50 years from the protection afforded by the statute and support its continuation.

The Public Utility Holding Company Act serves as a consumer protection statute by barring private power companies from making acquisitions which do not make a utility more efficient and effective through integration and by permitting affiliate transactions only at cost. The maintenance of these structural protections are critically important to the 900 public power systems that purchase power at wholesale from investor-owned utilities because they encourage "least cost" planning by IOUs. If the Act were amended to allow privately-owned utilities to form unregulated generating subsidiaries, then these public power systems that are wholesale customers would be exposed to costs based on venture capital rates of return.

While some have talked of providing regulatory safeguards for states' commissions to protect retail customers, there has been no mention of similar protections for wholesale customers. Given the inclination of the current Federal Energy Regulatory Commission (FERC) to approve market-based pricing, it is unlikely that affiliate transactions and wholesale contracts of utilities that own affiliates would be sufficiently reviewed to protect wholesale customers from self-dealing and cross-subsidization.

Public power systems support increased competition in the bulk power market. However, simply amending PUHCA to release privately-owned utilities from Securities and Exchange Commission (SEC) scrutiny will not provide competitive benefits to public power systems. Increasing the number of generators does not create competition. For competition to occur, purchasers must have ready access to multiple potential suppliers. For public power systems --which traditionally have a small service territory proscribed by city boundaries -- it is unlikely for multiple generators to be able to locate within the utility's service territory. Consequently, transmission service is necessary for these systems to access alternative generators located outside the service territory to reap the benefits of a competitive bulk power market. Unfortunately, many public power systems are dependent on the transmission lines of the neighboring investor-owned utility. Because the neighboring IOU is frequently the wholesale supplier for the public power system, the IOU is often unwilling to provide transmission service under equitable terms.

Even if the proposed changes would increase the number of entities in the bulk power market, public power -- which serves 15 percent of all of the nation's consumers -- could effectively be shut-out from the competitive marketplace unless transmission access is simultaneously required.

AMENDMENTS TO PUHCA ARE UNNECESSARY TO CREATE INDEPENDENT MARKET

Independent Market is Flourishing

Much of the debate over the Public Utility Holding Company Act has centered on the need to amend the Act to allow independent power producers to meet the growing demand for power as surplus generating capacity diminishes in some parts of the country. However, even without changes to the Act, the independent power industry is booming and will continue to grow.

Spurred by the enactment of the Public Utility Regulatory Policies Act of 1978 (PURPA), the non-utility power generation market has grown dramatically in the last 12 years. Last year, for example, independent developers built -- under existing law -- more generation capacity than traditional electric utilities. During 1990, 224 independent projects totaling 6,300 mW entered service and another 268 projects representing 35,000 mW were announced, nearly twice the totals announced in 1988 or 1989, according the consulting firm of RCG/Hagler, Bailly Inc. Traditional utilities built 5,700 mW of new capacity in 1990, according to the Utility Data Institute.

The total of 60,000 mW under construction or in development is an increase of 16,000 mW or 36 percent from the 44,000 mW of projects reported in the same category last year. A total of 38,000 mW of independent power capacity are currently in operation.

The independent market is expected to continue to grow. For 1991, the number of independent projects announced is likely to be the same or near that of 1990, with similar totals in 1992 and 1993, according to RCG/Hagler, Bailly. Independent power capacity could reach 200,000 mW by the year 2000, including 100,000 mW from load growth and another 100,000 mW through the utility capacity replacement market, according to the Independence Power Corp.

These figures strongly suggest that lifting the Act's restrictions on independent power producers is not necessary to encourage alternative bulk power suppliers. Independent power producers are abundant and growing. In addition, every bid solicitation for power has been oversubscribed. For example, as of 1989, out of all bid solicitations, supplies of 3,039 mW were requested and bids totalling 19,568 mW were received.

A sampling of non-utility offerings to public power bid solicitations between 1989 and 1991 indicates that the independent market is healthy.

- Orlando Utilities Commission solicited bids for 440 mW and received 19 notices of intent representing 5,590 mW.
- Los Angeles Department of Water and Power received 352 project proposals totaling over 33,050 mW before its solicitation for 600 mW was even issued.
- Northern California Power Agency solicited 330 mW in a request for proposals that attracted 67 bids totaling 3,580 mW.
- Sacramento Municipal Utility District called for 1,000 mW and drew 94 proposals from 59 bidders totalling 14,665 mW.
- American Municipal Power-Ohio called for 175 mW and got 13 proposals from 11 bidders who offered 1,045 mW.

Attached is a complete listing of "non-utility" offerings between 1989 and 1991 documented in Electric Utility Week.

Restructuring as "Independent" Producers

The narrow Public Utility Holding Company Act exemption in PURPA has not only encouraged a burgeoning market for true independent power producers but has also initiated the beginning of a major restructuring of the traditional vertically integrated utility industry with the advent of a number of generating affiliates of private power companies, or as one consumer advocate says, the oxymoronic "independent affiliate." As of November 1988, utility power affiliates were involved with projects totaling about 11,350 mW, nearly triple the 4,400 mW total of a year earlier. These figures discount for the project shares of other partners.

In 1989 there were 34 utility power affiliates that made project commitments, compared to 28 in 1988. In addition, there are three functioning affiliates without project commitments, three units awaiting regulatory approval of formal establishment, and six affiliates that are inactive or terminated.

Recently, new power affiliates were formed or proposed by American Electric Power, Florida Power, Kansas Power & Light, Montana Power, Pacific Gas & Electric (with Bechtel) and Tampa Electric. In addition, three utilities or utility holding companies that already have independent power affiliates -- Eastern Utilities Associates, Duke Power and Potomac Electric Power -- formed second subsidiaries to seek out different markets or perform different functions in the non-utility field.

The largest utility affiliates include: Southern California Edison's Mission Energy; Consumers Power's Midland Cogeneration Venture; Baltimore Gas & Electric's Constellation Holdings; Florida Power & Light's EST Energy; Niagara-Mohawk Power's Hydra-Co Enterprises; Pacific Power & Light's Onsite Energy; Public Service Electric & Gas' Community Energy Alternatives; Utah Power & Light's Energy National Company and Dominion Resource's Dominion Energy.

The creation of utility affiliates is capable of dramatically transforming the structure of the electric utility industry in undesirable ways. Utilities are increasingly less concerned with serving their captive retail customers as they seek higher profits for affiliates. Moreover, regulators are faced with substantially more complex utility corporate structures that frustrate effective regulatory scrutiny. As a result, abuses are more likely to occur and less likely to be detected.

APPA is concerned by this possibility since many of its members are captive wholesale customers of investor-owned utilities that might form electric generating subsidiaries outside the scope of PUHCA. These captive customers are unable to avoid this potential for abuse since they are unable to access the nation's transmission grid to locate alternative suppliers.

Potential $9.4 Billion Consumer Heist

Lifting the Act's restrictions will most likely accelerate industry restructuring and result in **more utility-owned affiliates -- not truly independent bulk power suppliers.** With monopoly control over transmission lines and access to cheap financing backed by captive ratepayers, utility-owned affiliates will have an unfair competitive edge over smaller "true" independents resulting in a less, not more competitive market. The "competitive" aftermath of unleashing large utilities in the independent market will mirror what occurred following airline deregulation -- few survivors, higher rates, and little competition.

Earning greater profits for stockholders, not serving the public interest, is why many investor-owned utilities are venturing into the independent power market. Pacific Gas and Electric (PG&E) has joined with Bechtel Corp. to build and operate independent power facilities. At the same time, PG&E announced it will meet future load requirements with conservation and renewables. Apparently, all of PG&E's construction will be non-ratebase unregulated ventures in distant locations. Why? Profits. The usual rate of return on equity for ratebased utility investments has been about 10 percent. According to Richard A. Clark, PG&E's chairman and chief executive officer, several of the independent projects that are expected to start operating in about two years will contribute returns of 18 to 20 percent to the company.

PG&E is not alone in its desire to make big profits from "independent" power ventures. In Michigan, Consumers Power has signed a contract to buy electricity from its Palisades Generating Company affiliate that may result in Consumers Power paying $7 billion for power that, according to Michigan consumer advocates, should cost around $5 billion. **The $2 billion excess profit is enough to provide free electricity to all of Consumers Power's customers for more than a year.**

Extrapolated over the entire utility industry, the potential profits, and the costs to ratepayers, are staggering. IOUs have approximately $94 billion of equity in their regulated generating operations. Under regulation they are permitted to earn about 10 percent on this equity. If IOUs could transfer this equity capital to non-regulated IPP affiliates they could earn a rate of return estimated between 18 and 22 percent. A 10 percent rate-of-return on $94 billion of equity could be transformed into a 20 percent unregulated rate of return. A return of $9.4 billion per year might be doubled to $18.8 billion. Electric ratepayers would pay twice the return for exactly the same service they now receive.

Ironically, while the IOUs would double their return on equity, they would do so while incurring less risk. Regulatory disallowances of imprudent investments have exposed IOU stockholders to some risk. By channeling investment in new electric generating capacity through nonregulated affiliates, this risk is transferred from stockholders to ratepayers. Ultimately, the risk of a failed venture -- or even poor returns -- are borne by the captive ratepayer through the downgrading or the parent utility stock and bond rating. Utility affiliates will earn excessive returns despite the fact that the same utility employees build the plants. Their experience and technical competence is not transformed by the corporate shell game. What is changed is that regulatory cost discipline is removed and captive electric ratepayers are required to pay twice as much for the equity investment as was previously paid. The service that ratepayers receive is unchanged. Despite the higher rate of return on equity, the solicitous IOU parent guarantees that its affiliated "independent" power producer pawn is sheltered from genuine risk.

PURPA Goals Pulverized

Another victim of the proposed amendment to the Act contained in S. 341 is PURPA itself. PURPA was enacted not simply to encourage alternative power producers, but certain types of efficient power producers. To that end, PURPA requires certain standards of efficiency for non-utility generators to qualify for "QF" status and an exemption from the Holding Company Act. The proposed amendment to the Act frees independent producers from the efficiency requirement, **effectively destroying the main purpose of PURPA.** Cogeneration and renewables would be discouraged because larger conventional facilities would likely win competitive bids.

BREEDING GROUND FOR ABUSE

Restructuring the utility industry by freeing generation subsidiaries from the restraints of the Act is not a risk free method of meeting the growing need for additional power in the '90s and beyond, as proponents of amending the Act claim. In fact, consumers, who ultimately pay for utility misadventures, are exposed to greater risks from a bulk power market dominated by utility affiliates free from the consumer protections of the Act and state public utility commission review.

Allowing the creation of "independent" utility affiliates creates considerable opportunities for abuse of monopoly power. For example, a utility could "self deal" with its affiliates at inflated rates to benefit stockholders at the expense of ratepayers. Also, a utility could force its captive retail and wholesale ratepayers to cross-subsidize its unregulated ventures by furnishing design, engineering, and capital to its affiliates at bargain prices. More subtly, a utility could transfer its best engineers or managers to an affiliate leaving less experienced or capable employees to operate their ratebased facilities serving captive customers. Such a "brain drain" would be virtually undetectable by even the most effective state public utility commission. **In each case, the ratepayers foot the bill while the stockholders reap the profits.**

Commissioner Ronald E. Russell, Michigan Public Service Commission, said in a speech to the American Bar Association on March 8, 1991:

> Relying solely on after-the-fact rate reviews to protect consumers from utility holding company abuses is like trying to eat a meal with only one chopstick and both hands tied

> behind your back. You can be somewhat effective holding the chopstick with your feet and bringing food up to your mouth, but there are many foods that you won't be able to manage completely and more you couldn't even attempt...**The key to mitigating utility abuses is to prevent them from happening in the first place.** The preacquisition reviews that are provided for in the Holding Company Act are intended to prevent the creation of corporate structures that are inherently susceptible to abusive behavior. **The more complex the corporate relationships, the more difficult it becomes to detect abusive transactions.**

Abuses Happening Now

Concerns about these abuses are not speculative: they occurred prior to enactment of the Act, and they have occurred under the more narrow PUHCA exemptions contained in PURPA. PURPA permits utilities to own up to 50 percent of qualifying facilities under a holding company structure while avoiding regulation as a holding company. Actions by utility affiliates under PURPA provide a crystal ball on what might happen if the Act's restraints are lifted.

Southern California Edison: The California Public Utility Commission concluded that transactions between Southern California Edison (SCE) and its "independent" affiliate, Mission Energy, "have reflected a disregard for the appearance of self-dealing and, in some instances, have resulted in placing [Mission Energy's] interest ahead of those of its ratepayers." Concerning a non-standard contract between SCE and Mission, the Commission noted "many significant contract terms which placed Edison's ratepayers at greater risk than those contained in Standard Offers" and disallowed $48 million of excess charges under the contract.

The California Division of Ratepayer Advocates found with respect to another affiliate of SCE in its involvement in two projects that:

- SCE failed to cancel the Sycamore contract at a time when it knew that the contract would cost its ratepayers hundreds of millions of dollars more than avoided costs, even though it had negotiated the explicit right to cancel the contract for any reason;

- SCE extended development deadlines for the Watson project, thereby preventing the termination of the contract, without obtaining any ratepayer benefits in exchange; and

- SCE gave Watson dispatch provisions, which Watson needed to obtain a permit, even though SCE knew the provisions to be worthless to the ratepayer.

The Division of Ratepayer Advocates recommended that the state commission prohibit SCE from entering into any new purchase power agreements with affiliates and requested that SCE divest itself of ownership interest in affiliates with which it does business.

Consumers Power: In Michigan, the Public Service Commission concluded that the power purchase agreements between Consumers Power and its affiliate, Midland Cogeneration Venture (MCV), "did not result from arm's-length negotiations" and that "the needs of Consumers' ratepayers have taken a back seat to the needs of MCV." The Commission found that Consumers put its ratepayers at risk due to its significant financial exposure under its contract with MCV and that Consumers created various affiliate corporate entities to evade regulation.

Tucson Electric Power: Abuses between utility parents and their affiliates have even occurred outside the PURPA context. The Arizona Corporation Commission (ACC) reviewed the power sale agreement between Tucson Electric Power Company (TEP) and its wholly-owned subsidiary Alamito, which was spun-off to TEP's stockholders as an independent power wholesaler then sold to Catalyst Energy Corporation. The ACC concluded that the spin-off was not the result of an arms-length transaction or free from self-dealing and found that TEP's actions reflected "its emphasis on shareholder/management compensation and disregard for its customers and this regulatory commission."

These abusive practices raise additional concerns about the amendments to the Holding Company Act. Despite the exemption contained in PURPA, holding companies continue to be subject to a case-by-case administrative exemption process and face the possibility that an exemption to the Act could be withdrawn by the Securities and Exchange Commission if the SEC finds the exemption to be detrimental to protected interests. Under the proposed amendment to PUHCA, only an act of Congress could remove or repeal the exemption if, as expected, abuse occurs. This both encourages abuse and protects the abuser from penalties.

Close PURPA Loopholes or Force Divestiture

The Consumers Power, Southern California Edison and Tuscon Electric examples clearly demonstrate that affiliate corporate structures are breeding grounds for abuse and can only be prevented by barring such structures in the first place. Therefore, the Act's restrictions on affiliates must be enhanced by eliminating a regulatory loophole in PURPA allowing utilities to own 50 percent of qualifying facilities. Alternatively, utilities who want to form generation affiliates and participate in a less regulated and potentially more profitable (and thus riskier) bulk power market should divest their distribution and transmission monopolies, assume the risks themselves and meet the competitive challenge on an even playing field with true independents.

Financial Risks

In addition to the risks of rampant holding company abuse under S. 341, the increased reliance on non-utility generators may result in lower credit ratings for utilities, according to Moody's Investor Service and Standard and Poors (S&P). An increasing reliance would mean a corresponding decreasing reliance on a utility's own plant, said an S&P report issued in March, 1990. With new plant investment tapering off and the existing rate base gradually liquidated through depreciation, "eventual earnings growth and internal cash generation will be limited...And as earnings stagnate, management may be compelled to resort to riskier strategies to enhance shareholder value."

Moody's noted that in contracting to buy power, "clearly construction risk is often reduced, however, significant operating, financial, and regulatory risks many remain and outweigh perceived benefits." Moody's also pointed out that any incremental risks assumed by the alternative bulk power suppliers are not offset by an opportunity for the utility to earn a profit on such contracts.

For instance, Virginia Power's growing reliance on independent power purchases has caused some concern at the Virginia Corporation Commission. The Commission is exploring the extent of risk associated with dependence on purchased power and may exercise greater oversight of VEPCO's purchase power strategy.

Another financial risk results from the financing IPPs traditionally use to capitalize projects: owners of highly leveraged projects that finance with 90 percent or more non-recourse debt will have little incentive to continue operating if the project's economics become unfavorable. IPP developers may simply walk away from such projects leaving the purchasing utility -- with a need for the project's power coupled with an obligation to serve -- holding the bag with the option of either taking over an uneconomic project or renegotiating the contract on terms more favorable to the operator. Either way, the ratepayer pays.

REAL COMPETITION REQUIRES TRANSMISSION ACCESS

Public power has never shied away from competition. For over 100 years, public power systems, representing 15 percent of the industry, have been the primary competitive force in the electric utility industry. Public power has also been the leading advocate of increased transmission access to high voltage transmission lines at nondiscriminatory prices to allow all utilities -- and all consumers -- to benefit from alternate bulk power providers.

To benefit consumers, fair competition in the bulk power market requires that multiple sellers and buyers have access to each other through existing transmission lines and have an opportunity to participate in the construction of new lines. Title XV of S. 341 -- and the Holding Company Act amendments in Title IV of the Administration's bill -- fails to include any transmission requirements. Any bill purportedly designed to increase competition in the bulk power market must include provisions to increase transmission access to ensure that all utilities are able to receive the benefits of additional players in the bulk power market.

Absent the inclusion of transmission provisions, transmission dependent utilities -- particularly those with small service territories -- will not receive any direct benefit from an allegedly "competitive" bulk power market. Investor-owned utilities with transmission monopolies could simply refuse to wheel power from independents or charge excessive rates for this service, especially if a "true" independent is competing with an IOU or its affiliate.

Transmission access will also promote efficient sizing and operation of independent power producers. Absent transmission requirements, independent power producers may not be able to make off-system sales that would improve the efficiency and economics of a unit. For instance, units would have to be scaled down or operations restricted to serve only single customers, losing the economies of selling excess power to multiple buyers.

In addition, transmission access allows the "next best" bid to sell to an adjoining utility if it is economic. A rejected bid may still be more economic than any facility that can be built in an adjoining service territory. The provision of transmission will allow these economic benefits to be enjoyed.

Transmission access prevents the use of essential services to disadvantage other bidders. Unless all bidders are provided transmission service under equal terms, a utility could provide an affiliate with preferential transmission rates and terms and distort the system.

Finally, transmission access creates a market mechanism to discourage cross-subsidization. Exposing a utility with otherwise captive wholesale customers to competition can check consumer abuses. A utility cross-subsidizing its "independent" affiliate with funds garnered from wholesale customers would run the risk of losing those customers if transmission service is available at reasonable cost to allow them to secure alternative power sources.

Transmission Momentum

Increasingly, transmission access is being recognized as the key element in the debate on the future of the electric industry and the momentum toward a system of non-discriminatory or open access and cost-based pricing appears to be building.

In October, 1989, the FERC Transmission Task Force issued its report entitled "Electricity Transmission: Realities, Theory and Policy Alternatives." The report recognized that transmission is a separate market, transmission monopoly power is often used to stifle competition and lack of access will be a substantial barrier to entry for an emerging, competitive generation industry. The report urged the FERC to adopt a consistent national transmission policy. Also in 1989, the Office of Technological Assessment of the United States Congress in its report, "Electric Power Wheeling and Dealing: Technological Considerations for Increasing Competition," found no technical impediments for increasing transmission access.

President Bush's National Energy Strategy released in February called for expanding access to transmission. So did the National Independent Energy Producers (NIEP) in their most recent position paper on PUHCA amendments released in February, 1991. NIEP would require utilities with affiliated power producers to file at FERC a transmission tariff that sets out terms and conditions for access to their system. Finally, House Democrats and Republicans are reportedly drafting Holding Company Act legislation that contains transmission language. Clearly, transmission is relevant and this fact is accepted by a growing number of the parties involved in the debate.

A Modest Proposal

Although FERC was given broad power under the Federal Power Act and subsequent court decisions to regulate pricing terms and conditions for wholesale transmission and wheeling services, and additional authority to mandate wheeling under circumstances specified under PURPA, it is the FERC's own view that it lacks authority to carry out the federal government's recommendations on transmission access and joint planning. Therefore, Congress should adopt legislation giving the FERC specific authority to:

- order utilities with generating affiliates to file a general transmission tariff; and
- order jurisdictional utilities to provide transmission services under just, reasonable and non-discriminatory rates, terms and conditions and increase transmission capacity if it finds it desirable to conserve energy, promote the efficient use of facilities and resources, increase competition in the bulk power supply market or is otherwise in the public interest;

In addition, legislation should be enacted to revive Fish and Wildlife Service, Bureau of Land Management, and Forest Service regulations requiring holders of transmission line rights-of-way through federal land to make excess capacity available for wheeling power from other systems.

CONCLUSION

The debate over the Public Utility Holding Company Act of 1935 is misfocused and misleading. Proponents forecast a decade of blackouts and brownouts without amendments to the Act. In fact, the lights will not dim or go out and independent power producers will not wither and die. Utilities will meet future capacity demands by building plants under ratebase, conservation, and purchases from a growing independent bulk power market.

Title XV of the National Energy Security Act of 1991 allows an unnecessary and radical restructuring of the utility industry. It allows investor-owned utilities to earn excessive profits at the ratepayer's expense. Without provisions for transmission access or consumer protections, it portends a less competitive wholesale power market that would allow more opportunities for and less protection from utility holding company abuse.

Nondiscriminatory access to transmission lines is the key to increased efficiency and competition in the electric utility industry, not unleashing utility giants to dominate a growing independent power market and pick the pockets of consumers.

A 1989-1991 Sample of "Non-Utility" Offerings

- Orlando Utilities Commission solicited bids for 440 mw and received 19 notices of intent representing 5,590 mw (the three final bids totaling 1,276 mw were rejected because it was less expensive for the utility to build its own capacity).
- Commonwealth Energy System decided to buy 116 mw out of 28 bids totaling 945 mw.
- Consolidated Edison received 36 supply bids totaling 3,096 mw from its solicitation for 200 mw.
- Oglethorpe Power secured 36 bids totaling 7,200 mw in response to its request for proposals for 700 mw of outside power.
- North Carolina Eastern Municipal Power Agency's 240 mw solicitation for peaking capacity drew nine proposals from five bidders totaling 454 mw.
- PSI Energy sought 550 mw by 1995 and 1,300 mw by the year 2000 and received 14 supply-side bids totaling 1,800 mw.
- Northern California Power Agency solicited 330 mw in a request for proposals which attracted 67 bids totaling 3,580 mw.
- Los Angeles Department of Water and Power received 352 project proposals totaling over 33,050 before its solicitation for 600 mw was even issued (final submissions reduced to 40 propositions totaling 4,085).
- Niagara Mohawk Power Company sought 350 mw of new supply and stimulated 105 proposed projects with total capacity of about 8,700 mw.
- Sacramento Municipal Utility District called for 1,000 mw and drew 94 proposals from 59 bidders totalling 14,665 mw (though the net figure was 8,669 mw after subtracting 22 duplicate projects).
- Long Island Lighting's solicitation for 150 mw attracted 21 bids totaling 1,770 mw.
- New England Power selected power projects totaling 204 mw from a pool of 73 bids totaling 4,729 mw.
- Public Service Electric & Gas called for 200 mw and received proposals from about 200 projects totaling roughly 5,000 mw.

- Sierra Pacific Power got 39 separate proposals from 29 different companies offering approximately 2,600 mw in response to a request for 200 mw.

- Florida Power & Light's solicitation for 800 mw attracted 107 responses totaling 27,634 mw from companies interested in submitting official proposals (31 proposals from 24 bidders were ultimately received).

- Virginia Power called for 1,100 mw and obtained bids from 38 developers proposing 78 projects totaling 11,600 mw.

- Orange & Rockland Utilities asked for 150 mw of supply- and/or demand-side management and received 15 supply-side bids totaling 1,395 mw.

- Central Vermont Public Service drew 28 bids representing about 658 mw when it sought 50 mw.

- American Municipal Power-Ohio called for 175 mw and got 13 proposals from 11 bidders who offered 1,045 mw.

- Jersey Central Power & Light got 19 bids representing 712 mw of generation in its total solicitation for 270 mw of demand- and supply-side propositions.

- British Columbia Hydro received 24 proposals totaling 1,240 mw when it asked for 150 mw, and its subsidiary Powerex received 19 proposals totaling 4,000 mw when it sought to secure supply between 400 and 600 mw.

- Bangor Hydro-Electric received 25 bids totaling 800 mw when it asked for 60 mw.

- Ontario Hydro got 38 proposals totaling about 3,800 mw in "pre-application" responses to a solicitation for an unspecified amount of independent power.

- Boston Edison's 200 mw solicitation drew 48 bids totaling 2,800 mw.

- Central Maine's solicitation for 700 mw attracted 38 bids totaling nearly 2,400 mw.

- Western Massachusetts Electric drew 11 bids of 381 mw when it sought 54 mw.

Source: Electric Utility Week

COMMENTS OF THE AMERICAN PAPER INSTITUTE, INC. ON PROPOSED LEGISLATION TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT

The American Paper Institute appreciates the opportunity to submit its views to the Senate Committee on Energy and Natural Resources on Title XV of S.341 and on the Administration's National Energy Strategy, S.570.

The American Paper Institute (API) is the national trade association of the pulp, paper and paperboard industry whose 175 member companies produce over 90% of the nation's pulp, paper and paperboard. API's members are major industrial purchasers of electricity, with an annual electric bill of over $2 billion.

The renewed emphasis on energy conservation, energy efficiency and the use of alternate fuels embodied in S.341 and the Administration's National Energy Strategy, have remained the paper industry's goals since the last energy crisis in the 1970s. The paper industry has made significant strides toward those objectives, increasing its use of renewable biomass and residue sources of energy to 56% of its energy supply.

The paper industry is also the Nation's leader in the cogeneration of electricity (according to the Manufacturers Energy Consumption Survey) producing 45 billion kwh in 1989 alone. Consequently, API is in the unique position of representing not only substantial industrial electric consumers but also substantial electric producers as well.

I. API AGREES WITH THE GOALS OF THE NES

The Administration's National Energy Strategy has as its principal aim "a more efficient, less vulnerable, and environmentally sustainable energy future ... A keystone of this strategy [is] continuing the successful policy of market reliance." (National Energy Strategy, p.2)

The paper industry strongly endorses these objectives, although it believes it is questionable whether amendments to the Public Utility Holding Company Act will assist in meeting these goals.

II. PUHCA WAS ENACTED TO PROTECT THE PUBLIC

The Public Utility Holding Company Act (PUHCA) was passed by Congress in the 1930's in part to require operating utility companies to focus their efforts on utility operations. The statute requires registered utility holding companies to keep their financial structures from becoming too complex, and their investments from straying far afield from the utilities' principal responsibility of providing electric power to the public at retail. The legislation thus encourages utilities to maintain a strong capital base for utility operations, which promotes reliable electric service. It also limits the ability of utilities to use ratepayer assets to fund non-utility investments through holding companies and thus restricts the potential for inflation of electric rates through cross-subsidization schemes.

III. THE ASSUMPTIONS UNDERLYING THE CALL FOR CHANGES TO PUHCA

The proponents of PUHCA reform start from the premise that demand for power is increasing at a rate that will outstrip the utilities' ability to meet that demand in a cost-effective manner under traditional regulation.

The proponents then build upon the premise with the following assumptions that are necessary to make the case for PUHCA reform:

1. A shortage of steam hosts will prevent qualifying cogeneration facilities under PURPA from playing a meaningful role in meeting new power demand;
2. A shortage of cost-effective renewable fuel resources will prevent qualifying small power production facilities under PURPA from playing a meaningful role in meeting new power demand;
3. PUHCA-related impediments to IPP development will prevent significant IPP construction from emerging.

While the paper industry does not take issue with the premise that the demand for power will increase, thus necessitating cost-effective measures to meet that demand, API questions the three assumptions that build upon that premise.

IV. QUALIFYING FACILITIES CAN CONTINUE THEIR ROLE IN MEETING THE NATION'S ENERGY GOALS

Congress passed Public Utility Regulatory Policies Act (PURPA) in 1978 to encourage the cost-effective development of power technologies that utilized fuels more efficiently or that used fuels that were renewable. Use of more efficient and renewable fuel technologies, called qualifying small power production facilities and qualifying cogeneration facilities (QFs), would reduce the nation's dependence on fossil fuels, particularly imported oil, and would lead to a cleaner environment. Not only has cogeneration technology proven effective in using fuel more efficiently, thus conserving energy, but it also produces energy with lower net emissions than conventional utility generation. Moreover, PURPA implementation has demonstrated the feasibility of competition in the electric generating industry. In similar fashion, S.341 has as its underlying purposes the reduction in use of imported oil, the encouragement of competition, energy efficiency and fuel diversity.

The goals embodied in PURPA are consistent with the goals set forth in S.341 as well as in the President's National Energy Strategy. The paper industry does not see any need to create incentives for the development of other power producers, especially those that will not bring to the nation the energy conservation and environmental benefits of QFs, unless it is conclusively demonstrated that QFs, combined with traditional utility construction, will be unable to meet the nation's power needs on a cost-effective basis. The paper industry does not believe such a demonstration has been or can be made.

A. The Cogeneration Potential In the United States is Still Enormous

The claim in the background statement to the PUHCA section of S. 341 (at p.S1555) that "future development of cogeneration is becoming increasingly restricted as available steam hosts are used up" ignores the enormous cogeneration potential that still exists in this country. In the pulp and paper industry alone, potential new cogeneration in this country exceeds 300,000 MW. By potential new cogeneration, we mean cogeneration facilities that would meet the FERC operating standard for a qualifying cogeneration facility at existing pulp and paper company sites but which are now not on-line or under construction. Of course, new potential cogeneration will be limited by a number of practical constraints, including the availability of fuel, electricity prices, environmental impacts, site limitations and investment strategies. But, to varying degrees, these are the same constraints that will affect any power project development.

We derived the paper industry cogeneration potential by calculating the steam use requirements at representative integrated and non-integrated paper mills. From these requirements, it is possible to calculate the maximum electrical output that can be produced from a cogeneration facility that will meet the 5% FERC operating standard. The 300,000 MW of new cogeneration potential from the pulp and paper industry reflects the current steam use requirements at the industry's mills that are not currently utilizing cogeneration to the maximum extent permissible under the operating standard.

Approximately 85% of the mills' capacity, and thus potential cogeneration capacity, is located in the following states: Alabama, Arkansas, Florida, Georgia, Louisiana, Maine, Michigan, Mississippi, North Carolina, Oregon, Pennsylvania, South Carolina, Texas, Virginia, Washington and Wisconsin. Coincidentally, these states are found in regions of the highest projected need for power in the next decade: the Southeast, Northeast, the northern Midwest, and the Pacific Northwest.

In 1989, the North American Electric Reliability Council (NERC) projected a need for 93,000 MW of additional electric capacity by 1998, including a need for 14,000 MW in the West, 30,000 MW in the Southeast, 13,000 MW in the northern Midwest, and 12,000 MW in New York and New England. As you can see, the paper industry potential alone could meet a large portion of the projected demand.

The paper industry believes that other industries could show a similar pattern of potential for cogeneration development nationwide. The evidence is already there.

First, utility bidding programs for new capacity throughout the nation have routinely produced a 10 to 1 ratio of bid capacity to needed capacity, and most of those bidders have been QFs.

Second, the actions of various state commissions in restricting qualifying facility sales to utilities belies the claim that steam hosts for cogeneration are limited. State commissions from Florida to Maine to Michigan to California have severely limited QF sales to utilities because of a glut of potential cogeneration waiting to be developed, not a shortage.

In addition, the analysis in the background statement to S. 341 wholly ignores the new steam hosts that will be developed as a result of American industrial expansion in the future.

B. Renewable Fuels Have Not Been Demonstrated To Be In Short Supply

Renewable fuels currently eligible for inclusion for QF status include geothermal, solar, wind, water, biomass and all manner of waste, including municipal waste. While economic solar and wind potential may be somewhat limited, the potential use of the remaining fuel sources, particularly biomass and waste, is substantial. Congress apparently recognized this greater potential for use of renewable fuels in passing legislation just last year which lifted the 80 MW ceiling on solar, wind, geothermal and waste-fueled QFs. Both S. 341 and the Administration bill would lift the ceiling on all renewable-fueled projects, a step which the paper industry supports. Moreover, the Administration's National Energy Strategy seeks to encourage the development of waste to energy projects, which it projects to be capable of producing 2 quadrillion BTUs of energy by the year 2010 (NES at p.126).

For its part, the paper industry has greatly increased its use of renewable and waste fuels in electric and steam generation. Approximately 40 percent of the paper industry's total energy use in 1972 came from renewable and waste fuels. By 1989, the use of renewable and waste fuels by the paper industry increased to 56 percent. API members intend to continue to expand their utilization of such fuels.

C. Current Regulatory Controls on IPPs Will Not Preclude Development

The paper industry would draw the Committee's attention to the fact that the existing PUHCA statute provides a number of exemptions from SEC regulation where such regulation would not serve the interests of investors and consumers. Today there are far more utility holding companies with exemptions from PUHCA than there are registered holding companies under PUHCA.

Over the past three years numerous IPPs have been able to successfully negotiate long-term power contracts with utilities in competition with QFs under PURPA, and have structured themselves in a manner that avoids the need for registration under PUHCA. See: Doswell, Commonwealth Atlantic, Ocean State, Enron Power Enterprise, Dartmouth Power and Teco Power Services projects.

Consequently, we believe that IPP development is flourishing under the current regulatory regime.

V. THERE SHOULD BE NO PUHCA REFORM WITHOUT GUARANTEES OF COMPETITION AND CONSUMER PROTECTION

Given the beneficial role of PUHCA over the last 50 years, the continued ability of QFs to meet the power needs of the utility industry for new capacity, and the emergence of a thriving IPP industry without PUHCA revision, the paper industry is not persuaded that any modification to PUHCA is warranted at this time. However, if it is the will of Congress to impose changes on the statute in an effort to promote IPP development, the paper industry believes that Congress must include safeguards to assure that competition and efficiency in the power industry will be protected and enhanced, regulatory oversight will be effective, and the energy conservation and environmental benefits of QFs will be encouraged, as stated in Section 210 of PURPA. API takes strong exception to the view that PUHCA can be modified now to encourage IPP development and that consumer protection and transmission issues can be addressed separately at a later date.

API offers the following proposals:

1. Competition: The President's National Energy Strategy recognizes the importance of transmission service in the creation of a competitive generation market. Transmission service will also be essential to correct imbalance in regional supply and demand. The Administration's NES suggests that legislation to expand FERC's authority over transmission may be necessary. API submits that such legislation is needed now, particularly if PUHCA "reform" leads to an IPP industry that is dominated by investor-owned utilities that control the nation's transmission systems.

The paper industry believes that legislation to promote transmission service for all bulk power suppliers, including QFs, is important for workably competitive markets to flourish, even absent PUHCA reform. QFs today are being denied access to transmission by FERC in utility merger cases in part due to FERC's asserted belief that the Federal Power Act will not permit FERC to grant QFs transmission access. This problem must be remedied. PUHCA "reform" makes such legislation even more imperative.

API offers two alternative approaches to legislation on transmission service.

a. Amend the Federal Power Act to permit FERC to order utilities to provide transmission service to all power suppliers, including QFs, under non-discriminatory rates and conditions, including the ability to order the construction of additional transmission should bottlenecks occur, if it would be in the public interest to do so; or, at a minimum

b. Condition IPP ownership by utilities on their agreement to provide non-discriminatory transmission access to their systems. This approach would be analogous to the model put forth by PSI Energy, Inc. and approved by FERC last year.

2. Ratepayer Protection:

(a) State Oversight: State commissions must be given the express authority to disallow utility purchases of IPP capacity that are imprudently made. The paper industry suggests that IPP contracts with utilities be filed with the appropriate state commission and that any affected state commission be given a period of time (perhaps 3-6 months) after receipt of a notice of the filing of an IPP contract with FERC to initiate a state proceeding concerning the prudence of the IPP purchase. If the state does not initiate such a proceeding during the allotted time, the state would be barred from a later challenge to the prudence of the purchase. If a timely proceeding is initiated, and the state commission finds the purchase imprudent in whole or in part, the passthrough of payments can be disallowed.

(b) Utility Self-Dealing: Utilities and their affiliates must be barred from owning IPPs that sell power back to the utilities themselves unless they participate in a bidding process that utilizes an independent firm for project selection. The public must be permitted to participate in the determination of the bid criteria, and the state commission must be involved in the selection of the independent firm and oversight of its activities. The paper industry is greatly concerned about recent instances of abusive self-dealing by utilities and their affiliates which will only be exacerbated if PUHCA is modified.

(c) Utility Opt-Out Provision: Consumer protection concerns also cause the paper industry to question the wisdom of the Senate bill's proposal to allow utilities to opt-out of any purchase of IPP capacity for up to 10 years. The proposal appears to be inconsistent with the bill's sponsors' own assumption that IPPs will enhance competition and thus reduce ratepayer costs. Moreover, it will prevent state commissions from assessing the prudence of utility decisions to build or purchase capacity from non-IPP sources, which is inimical to ratepayer protection.

(d) The paper industry supports the basic approach of the Administration's PUHCA reform bill to permit the state commissions to determine the prudence of IPP purchases by utilities. However, certain details in the bill will need to be more closely examined to ensure that areas of federal preemption are limited to truly federal interests.

March 15, 1991

COMMENTS OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES (NASUCA) REGARDING TITLE XV OF S. 341 PUBLIC UTILITY HOLDING COMPANY ACT REFORM

CONGRESS OF THE UNITED STATES

SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

March 20, 1991

Submitted by:

Billy Jack Gregg
West Virginia Consumer Advocate
NASUCA Executive Committee
700 Union Building
Charleston, West Virginia 25301

National Association of State
Utility Consumer Advocates
1133 15th St., N.W.
Suite 575
Washington, D.C. 20005

COMMENTS OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES REGARDING THE PROPOSED AMENDMENTS TO THE PUBLIC UTILITY HOLDING COMPANY ACT.

On behalf of the National Association of State Utility Consumer Advocates (NASUCA), I wish to thank you for this opportunity to comment on Title XV of S. 341 which proposes certain amendments to the Public Utility Holding Company Act of 1935 (PUHCA). NASUCA is comprised of 43 state-appointed utility consumer advocates in 38 states and the District of Columbia, representing utility consumer interests in state and federal regulatory agencies and the courts. My name is Billy Jack Gregg. I am the Director of the West Virginia Consumer Advocate Division and am a member of the Executive Committee of NASUCA.

As primary representatives of utility ratepayers, the members of our organization are well aware that the protections in PUHCA are one of our first lines of defense against utility abuses. Accordingly, we are extremely concerned about any effort to dismantle or weaken the ratepayer protections contained in PUHCA. Because Title XV of S. 341 invites the very abuses PUHCA was passed to prohibit, NASUCA must register its strong opposition to the bill.

The concerns that led to the passage of PUHCA fifty-six years ago are still just as important today. NASUCA's consistent position opposing changes to PUHCA which weaken ratepayer protections and allow utility abuses is grounded in a series of resolutions adopted by the organization over a number of years. These positions and resolutions have previously been presented to Congress in written testimony before the Senate Committee on Energy and Natural Resources by Raymon E. Lark, Jr., Director of the Division of Consumer Advocacy of the South Carolina Department of Consumer Affairs in November 1989, and in written testimony before the House Committee on Energy and Commerce by Irwin A. Popowsky, Pennsylvania Consumer Advocate, in October 1990.

The Public Utility Holding Company Act was passed to correct actual abuses by electric holding companies. Under present PUHCA provisions, an electric utility holding company is limited to the business of supplying electricity to its customers within a geographically and electrically integrated system. A holding company is limited in the type of businesses it may acquire, and in turn, non-utility businesses are prohibited from acquiring electric utilities. Any affiliates created by a holding company to own and operate electric generating facilities are strictly governed by the provisions of PUHCA and SEC regulations. These limitations prevent holding companies from using ratepayer monies to subsidize entry into geographically distant regions and entry into speculative enterprises unrelated to utility business. These PUHCA restrictions reduce the risks for both ratepayers and investors.

S. 341 is a wide-ranging attempt to establish a national energy strategy. Unfortunately, Title XV of this bill eliminates certain restrictions on utility holding company corporate structures and diversification. Title XV creates a new category of electric utility called an "exempt wholesale generator" ("EWG"). As the name implies, an EWG is exempt from PUHCA, as are most transactions involving EWG's. There are no restrictions on non-utilities owning an EWG. Furthermore, there are no restrictions on utility ownership of EWG's, nor on the ability of an affiliated EWG to sell electricity back to the utility. The last section of Title XV permits electric utilities to insulate themselves from competition by opting out of purchases from EWG's for up to ten years by simply filing a declaration of such intention with the Federal Energy Regulatory Commission.

NASUCA's principal concerns with Title XV of S. 341 falls into three main areas: (1) self-dealing and cross-subsidization, (2) unfair competition and (3) erosion of state regulatory authority. Under Title XV an electric utility will be able to subsidize the operation of its unregulated EWG subsidiaries with cash provided by its captive utility operations, and will be able to sell electricity to itself at terms not negotiated at arms length.

Competition in the generation of electricity will not be enhanced by Title XV because electric utility-owned EWG's will have immense advantages over truly independent EWG's. Besides having access to monopoly-generated monies through cross-subsidization, utility-owned EWG's will have access to the utility's transmission system for both internal and external sales. Independent EWG's, on the other hand, can be shut out by these transmission bottlenecks controlled by competitors.

Finally, the power of state regulators to control the actions of electric utilities under their jurisdiction will be greatly reduced. If a utility chooses to create EWG's and sell electricity to itself, the transaction is done at wholesale and not retail and is therefore removed from state jurisdiction. If a utility declares that it will not buy power from any EWG, no matter what the price, a state may not question that decision.

Our concerns are not speculative: many of these abuses are real and on-going, and will be exacerbated by Title XV of S. 341. A glimpse of the world without PUHCA protections have been provided by recent cases in Michigan, Arizona and California involving affiliated electric generating companies. These cases show self-dealing with affiliates and challenges to state authority to remedy abuses of the public interest.[1] The concerns raised by these cases underscore the importance of PUHCA in providing protection of the consumer welfare. The members of NASUCA are convinced that abuses would be more likely to result if PUHCA is weakened, as it would be in Title XV of S. 341.

The proposed bill eliminates a number of regulatory safeguards with respect to electric power generators, but provides no assurance that these safeguards will be replaced by true competition. Title XV of S. 341 allows self-dealing, cross-subsidization, and gives the utilities themselves the option of determining whether or not they wish to permit competition in their own service territories. These flaws will only lead to higher electricity rates, a shifting of risks to consumers, and an erosion of state authority over utility service.

Everyone can agree that our nation needs an energy policy. However, we don't have to sacrifice consumer interests to have energy security. Title XV of S. 341 will strip away existing consumer protections, but will not guarantee additional energy supplies at reasonable prices. It will only result in benefits for a few at the expense of the many. For these reasons the National Association of State Utility Consumer Advocates respectfully opposes passage of Title XV of S. 341.

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[1] An excellent review of these cases and of arguments against weakening PUHCA protections is found in the article "Self-Dealing: The Case Against Removing PUHCA Restrictions on Utility Affiliated Power Producers," by Cynthia Bogorad, The Electricity Journal, (January/February 1991), p. 45.